

# **A review of Internal Audit functions of nine Captive Automotive Financing Companies within the UK, Russia and Italy.**

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## **Abstract**

This paper examines the legal and regulatory frameworks applicable to Internal Audit (IA) functions of Captive Automotive Financing (CAF) Companies in the United Kingdom, Russia and Italy that impact on the audit structures, internal reporting lines and tasks and responsibilities. Captive Automotive Financing Companies are companies owned by car manufacturing companies to finance product sales of the car manufacturer. The data collected provided information to compare interdependences and relationships between the nine CAF companies and contributed to establishing a framework in assessing an effective IA function.

The results found that the UK and Italian companies IA function had greater deviations in terms of audit activities. The more detailed and rigid the regulation of IA, the more consistent is the allocation of average capacity per audit, while the activities of the IA functions are more in line with expectations and the reporting lines are more independent. The Russian regulations for IA in CAF Companies have the most binding of obligations compared to the UK and Italy.

Key words: internal audit, independence, regulatory frameworks,

## **Introduction**

The automotive industry is in an economic downturn and is trying to survive in unfavourable economic conditions. The ongoing globalisation and the development of emerging markets such as China and India towards powerful economic players has resulted in an increased demand for oil and raw materials in recent years. This has led to major price rises and increased costs for manufacturers (Bailey, 2008). High dependence of many car manufacturers on the US market as one of the biggest sales areas is creating serious problems due to the US's weak economic situation and in particular for European manufacturers because of the declining value of the US Dollar

(AFP, 2008). This is inter alia a result of the international financial crisis caused by the sub-prime mortgage fiasco in the US. ,

*“the scale of the resulting house price crash and slowdown in the economy is now impacting badly on the bottom line for the major auto manufactures”*

(Bailey, 2008, p.1).

In addition there is the negative effect of the economic downturn on consumer confidence. The deterioration in consumer confidence due to overall difficult economic circumstances is also reflected in European new passenger car registrations which fell 2.0% in the first half of 2008. Rising inflation and household costs as well as soaring fuel prices were among the main factors influencing new car registrations (ACEA, 2008).

Measures by car manufacturers to counter adverse economic conditions and increased competition are amongst others, cost reduction, increasing efficiency and the adoption of leaner structures, as well as in some instances government financial support. These measures do not necessarily encourage the continuous improvement of the internal control system that becomes a more important component of a company's governance system in unfavourable economic conditions (COSO, 2004). This is a critical development where internal auditing comes into play as an essential function in the areas of risk management, internal control and corporate governance.

The internal audit's knowledge of the company, its systems and processes is important for an organisation as it enables them to systematically analyse business, risk management and internal control processes and assess their effectiveness. The IA function provides value for the business through its independent reporting to improve the effectiveness of the processes and the use of its knowledge to disseminate good practices across the organisation (ICAEW, 2000).

In relation to the Captive Automotive Financing (CAF) Companies (which are separate companies owned by car manufacturers to finance product sales), the IA functions are very important as the financial services industry has generally more detailed and extensive regulations compared to most other industries. In reviewing the annual reports of car manufacturers the proportion of financial services operations compared to the industrial operation has continuously increased in recent years and highlights a rising relevance of the financial services business for car manufacturers. This in turn gives additional financial risks for the manufacturers as the adverse market conditions affect

the residual values of used cars with the result of lower revenues that can be generated on off-lease vehicles (AFP, 2008).

The current market and economic issues affecting the automotive industry increases the importance of IA functions for CAF Companies as an independent, objective assurance and consulting activity designed to add value and improve operations (ECIIA, 2005).

This research focused on IA functions of nine CAF Companies in the United Kingdom, Russia and Italy to analyse the implications of the country specific legal and regulatory frameworks for internal audit structures, internal reporting lines and tasks and responsibilities. The identification of interdependences and relationships provided further information for the car manufacturer to ensure an effective IA function within the CAF Companies. This research was part of a project sponsored by one car manufacturing company, but involved CAF companies owned by three different car-manufacturing companies.

## **Background**

In June 1999, the IIA officially adopted a new definition for Internal Audit stating that

*“internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”* (IIA, 2004a).

This definition recognises that in order to provide an effective service to management the traditional IA activities such as safeguarding of assets, fraud deterrence and detection, and compliance work need to be far broader (ECIIA, 2000). Internal Audit has developed in its potential to add additional value by extending the scope for IA activities by moving away from the policeman and watchdog image which has been present for many years (Sarens and De Beelde, 2006). This wider scope incorporates consulting services to represent the contemporary needs of well managed organisations in the present business environment that is essential in order to establish and maintain good governance (ECIIA, 2000).

Globalisation and continued advances in technology are increasingly affecting companies’ business models and their approaches to assurance and management of risk. The accelerating pace of change and growing complexity of operations in a global

marketplace make it even more difficult for management to identify and evaluate new risks (PWC, 2007). The survey conducted by PWC about the future of IA indicates that

*“globalisation, changes in risk management, advances in technology, talent and organisational issues, and changing internal audit roles will have the greatest impact on internal audit in the coming years”* (PWC, 2007, p.2).

The IA functions need to extend their roles and responsibilities and adapt a more strategic value proposition, which means incorporating,

*“the provision of risk management assurance along with the traditional responsibility of assurance over controls” to meet rising expectations with a risk-centric approach to delivering value* (PWC, 2007, p.5).

Rossiter (2007) supports the findings of the PWC survey and highlights the effects on the roles and responsibilities of internal audit due to new challenges, changes and expectations the IA functions have to meet. Internal auditors need therefore to place more emphasis on actual and future risk, assess internal control systems constantly, monitor the organisation’s risk profile and incorporate flexibility in the audit plan as well as the audit approach. Marks (2001) considers these new challenges do not just contain threats but also opportunities for IA functions to add additional value and become a major contributor to the internal governance system because of its unique position within the organisation. In order to keep up with the rapidly changing business world the IA functions have to continue evolving, start responding to the new demands and thus, move to the next level. The key roles and responsibilities of IA is generally to challenge current practices, to advocate ‘Best Practice’ and to be a catalyst for improvements with the overall aim of supporting the organisation in achieving its strategic objectives (IIA, 2008b).

The unique situation of IA as an independent but inside observer enables it to play an active role in keeping the board, senior management and external auditors informed about risk and control issues (Bookal, 2002). It is important to note that the traditional activities of analysing operations and ensuring compliance with applicable laws, regulations and guidelines in order to improve the performance of an organisation and achieve its overall objective still remain the fundamental responsibilities of internal auditors (IIA, 2008b).

The International Standards of the IIA define that IA should discharge its activities independently and objectively with an impartial and unbiased attitude to avoid conflicts

of interest. The International Standards stipulate that the IA function should report to a level within the organisation that allows the activity to fulfil its responsibilities. An independent status for the IA function is important as it enables management to place full reliance on audit findings and recommendations (Pickett, 2005).

In relation to the audit structure, there are three models typically classified as centralised, decentralised and outsourced model. The centralised model implies that the IA department is set up only in the parent company and carries out IA activities for all the subsidiaries. The decentralised model establishes an IA department in the parent company as well as in the main subsidiaries. (Allegrini et al., 2007).

Every organisational model has its advantages and disadvantages that influence the effectiveness of each model. These aspects must be considered in light of the nature and scale of the company when deciding on the most appropriate organisational model for the IA function (Allegrini et al., 2007). The two traditional models, centralisation and decentralisation, are distinguished by the distribution of power and decisions within the organisational system. It is concerned with the degree of autonomy possessed by lower levels and the assessment as well as consciousness of the degree of centralisation or decentralisation (Kolarska, 1983; Cullen and Perrowè, 1981). Centralisation

*“is an effective means to coordinate the decision making process in the organisation and to have a positive impact in terms of efficiency”. The increase of efficiency is achieved through the central coordination and control of activities which also justifies the unequal distribution of power (Allegrini et al., 2007, p.4).*

In contrast, the decentralisation model contains the opportunity to respond quickly to local conditions and environmental changes through an extensive scope of decisions power and room to manoeuvre. Mintzberg (1983) argues that centralisation and decentralisation should not be treated as absolute but rather considered as two ends of a continuum.

From a strategic perspective, each organisational model implies different effects and synergies. When grouping the IA resources at corporate-level, synergies within an organisation can be achieved. These positive effects come through the interaction of different processes, the transfer of skills and expertise to different value chains, and the sharing of activities amongst organisational departments (Porter, 1985). The use of the same resources has advantages related to economies of scale derived from the ability to

apply certain inputs for the production of several products or services (Grant, 1995). The execution of IA activities in a unit that provides its services to all the subsidiaries of the organisation has advantages through the shared application of knowledge, skills and methodologies for all units within the group. The benefits that arise from the centralised model are weighed against the related costs dedicated to coordinate the activities, compromise priorities and solve rigidities that might occur (Allegrini et al., 2007).

When considering the outsourcing model there are different advantages and disadvantages that require consideration. Rittemberg and Covaleski (1997) state that one reason for outsourcing the IA function is the fact that the outside provider has the expertise and skills that are not available and prove difficult to develop internally within smaller departments. It enables management to focus on core competencies and strategic plans instead of spending time on the day-to-day activities that require a great amount of capacity with little return. Sawyer et al. (2003) views outsourcing as having the advantage of delegating tasks to experienced professionals. Outsourcing can lead to increased flexibility as it allows a company to take a fixed cost and make it primarily a variable one. The independence of the contract IA function may be greater as it is unaffected by internal politics (Sawyer et al., 2003). On the other hand, the external provider could lack comprehensive understanding of corporate operations, internal control processes and risks of the business due to their remote position (Martin et al., 2000). In addition, the willingness of an external provider to criticise top management's activities may fall foul of the fear of losing the client. Conversely, in-house IA departments accumulate working knowledge about the day-to-day activities that enable them to identify weaknesses in the IA structure and to advise management more constructively (Martin et al., 2000). It is not only the fact that IA knows the business better than the external provider but they are also more loyal and connected with the organisation (Rittemberg and Covaleski, 1997).

Overall, the most appropriate organisational model and the independence requirements need to be implemented to ensure an effective and efficient performance of the IA function's roles and responsibilities (Pickett, 2005).

### **Research approach**

This research adopted the positivism position as this survey depended on a highly structured methodology to achieve the project objectives. The structured approach to gather data is supported by the positivism perspective in order to facilitate replication,

an important characteristic in this research (Gill and Johnson, 2002). This enabled a quantifiable collection and analysis of data necessary to identify interdependences and relationships between findings from each country. This research attempts to explain the causal relationship between the different legal and regulatory frameworks and the audit structures, internal reporting lines and allocated tasks and responsibilities of IA functions of CAF Companies. The deductive approach which is normally associated with positivism (Collis and Hussey, 2003) was selected as it is an important characteristic of the approach to explain causal relationships between variables. This approach is supported by the application of an independent and objective data collection through the use of questionnaires. The responses to the questions provide data to measure facts quantitatively to generalise the results from CAF Companies in the three countries. The main characteristics of the research refer to the deductive approach and the adopted research philosophy of positivism underpins this approach (Saunders et al., 2007).

The use of questionnaires to enabled a standardised collection of data and an easy comparison to derive law-like generalisations. This is important to accomplish the objectives as the research draws upon current practices and compares situations with recognised standards or regulations. There is a variety of definitions for the term “questionnaire” but in general, it refers to all techniques of data collection in which each person has to respond to the same questions in a predetermined order (deVaus, 2002). The right choice of questionnaire type and design is therefore important. There is usually just one opportunity to collect the data and it is important to work with standardised questions that can be interpreted in the same way by all respondents (Robson, 2002).

Questionnaires were emailed, (with a covering message) to participants who had areas of responsibility resting in the field of IA, internal control, risk management or compliance in general. This method of distribution enabled the identification of relevant and appropriate participants in an attempt to increase the reliability of responses. In general, the email administration offers greater control because most users read and respond to their own mail at their personal computer (Witmer et al., 1999). The answers are more likely to be free of ‘contamination’ as interviewees are not under any pressure from any face to face contact with an interviewer. Although it is still possible for respondents to discuss their responses with other colleagues and this may influence the result. (Dillman, 2000).

The design of the questionnaire followed the suggestions of Ghauri and Grønhaug (2005) to carefully review the literature, discuss the ideas widely and conceptualise the research clearly prior to designing the questionnaire. This helped ensure that it addressed the research; the respondent understood it in the way intended and it achieved the research objectives (Saunders et al., 2007).

### **CAF Companies in the UK, findings and analysis**

In terms of IA the recommendations of the Turnbull Report (1999) had an enormous impact on the recognition of IA functions in the UK,

*“the establishment, operation and monitoring of the system of internal control should be undertaken by individuals who collectively possess the necessary skills, technical knowledge, objectivity and understanding of the organisation and the industries and markets in which the company operates”* (Zama, 2001, p.6).

The report states that companies should regularly review the need for an IA function and it acknowledges that this need will vary depending on company-specific factors including the scale, diversity and complexity of the company’s activities and the number of employees, as well as cost/benefit considerations (Pickett, 2005). The Combined Code (2006) incorporated some of the Turnbull recommendations on stating that the board should maintain a sound system of internal control and annually review its effectiveness. The recommendations on IA are not legally binding, but these guidelines can be described as formal self-regulation and, impose a requirement on management of listed companies to comply or explain if they do not do so (Dewing and Russell, 2004).

The financial services industry in the UK has experienced major legal and regulatory developments from informal self-regulation to formal self-regulation and finally to direct regulation. The major change towards direct regulation of the financial services industry was the set up of the Financial Services Authority (FSA) in May 1997. It was established as a sole regulatory body for the financial services industry under the Financial Services and Markets Act 2000 (FSMA) effective December 2001 (Dewing and Russell, 2004). It initiated the regulatory restructuring of the industry with the aim of



*“creating a single system of regulation with the FSA regulating virtually the entire financial services industry” (Haynes, 2002, p.1).*

As a result, the FSA is responsible for the regulation of investment business, banks, building societies, friendly societies, credit unions, insurance companies and oversight of Lloyd’s insurance market. The FSA has a number of rule-making, investigatory and enforcement power in order to achieve its four statutory objectives which are to maintain market confidence in the financial system, to promote public understanding of the financial system, to secure an appropriate degree of consumer/investor protection and to reduce financial crime (Handley-Schachler, 2007).

The table below gives an overview of FSA regulated activities,

<b>Regulated Activity</b>	<b>Explanation</b>
Accepting deposits	Receiving deposits that will be repaid either with or without interest and on demand or at another time agreed by the parties
Contracts of insurance	Effecting and carrying out contracts of insurance
Arranging (bringing about) regulated mortgage contracts	Brokers who negotiate the terms of regulated mortgage contracts with the eventual lender, on behalf of the borrower
Advising on regulated mortgage contracts	Advising a person on entering into a regulated mortgage contract or on varying the terms of the contract in such a way as to vary his obligations under that contract
Arranging (bringing about) deals in investments	Making arrangements for another person to buy, sell, subscribe for or underwrite a particular investment
Advising on investments	Advising a person on buying, selling, subscribing for or underwriting regulated investments

**Table 1: Regulated activities defined by the FSA (FSA, 2005)**

The FSA Handbook of rules and guidance applies to authorised firms performing regulated activities and approved persons falling under the FSA authority. The FSA rules create binding obligations for firms conducting regulated activities and guidance is given to regulated persons to clarify particular aspects of regulatory requirements (FSA, 2005). This Handbook defines the activities that fall under their authority, but companies only offering vehicle financing and no other financial products do not fall under the FSA regulation. The FSA Handbook has an impact on IA under Rule 3.1.1 of the Systems and Control module that firms must take reasonable care to establish and maintain systems and control as appropriate to their business. The Handbook emphasises the need to have clear responsibilities and reporting lines to an Audit

Committee or appropriate senior management level. In addition, the Handbook recommends that the IA function should be independent of the day-to-day activities, adequately resourced and staffed by competent individuals and have appropriate access to firm's records (FSA, 2005).

In general, the FSA has enforcement powers to impose disciplinary sanctions such as fines or cancellation of authorisation on firms, employees of firms or in some circumstances against third parties in case of breaches against their Rules or other FSMA requirements.

The four participating CAF Companies in the UK are limited liability companies and do not need to possess a banking licence to provide the financial services products selected in Table 2.

	A		B		C		D	
	own account	external provider	own account	external provider	own account	external provider	own account	external provider
Vehicle Financing	x		x		x		x	
Vehicle Leasing	x		x		x		x	
Fleet Management	x		x					x
Insurance		x		x				x
Vehicle related Service Products	x	x	x	x		x		x
Current Account								
Savings Account		x						
Loans	x							
Mortgages								
Credit Cards		x				x		
Investment Services								

**Table 2: Summary of the financial services product categories offered by the UK CAF Companies**

The findings of this survey also indicate that the company size with respect to the *number of employees* is in the same range for three of the participating CAF Companies and just one respondent specified a higher number. Table 3 gives an overview of the number of employees comprised in the researched CAF Company in the UK.

	A	B	C	D
0-49				
50-99				
100-249				
250-499	x		x	x
>500		x		

**Table 3: Number of employees in the UK CAF Companies**

Question 4 of the survey asked for a description of the predominant structure of the internal audit department. The three models of outsource, centralised and decentralised along with a definition of two –tier structures were offered as options. The two tier structure was further defined into 4 categories, namely;

1. The group’s internal audit department co-ordinates all the local internal audit departments’ activities and also carries out audits within your financial services organisation
2. The group’s internal audit department co-ordinates all the local internal audit departments’ activities but does not carry out audits within your financial services organisation
3. The local internal audit department plans and performs activities autonomously and the group’s internal audit department also carries out audits within your financial services organisation
4. The local internal audit department plans and performs activities autonomously but the group’s internal audit department does not carry out audits within your financial services organisation

The participants mainly selected the *Two-tier structure 3* as the predominant structure of their IA function. Only respondent A selected the *Centralised model* which implies that the IA department belonging to the group but not belonging to the local financial services organisation performs IA activities. The responses relating to the organisational structure are combined in the following table.

	A	B	C	D
Outsourcing model				
Centralised model	x			
Decentralised model				
Two-tier structure 1				
Two-tier structure 2				
Two-tier structure 3		x	x	x
Two-tier structure 4				

**Table 4: Predominant organisational structure of the UK IA functions**

The *number of years* indicating how long the current IA structure has been in place varies; the shortest time is 2 years whilst the longest is 8 years, while the *number of annual audits* undertaken also varies. Table 5 illustrates the *number of audits carried out* within the CAF Companies the *man-days allocated* to carry out the IA activities, when viewed as a table it highlights the individual requirements of each CAF Company in terms of audit capacity and intensity.

	A	B	C	D
Years of existence of the specified IA structure	4	5+	2	8
Number of audits carried out within the CAF Company	13	6+	15-20	10
Allocated man-years to carry out IA activities	3	1	2	2.5

**Table 5: Research results about the years of existence, number of audits and allocated man-years in the UK CAF Companies**

The following calculation assumes that 1 man-year consist of 260 working days where 35 days are considered annual leave plus public holidays. On an assumption that 30% of the available 225 working days relate to non audit days of administrative tasks, trainings, sick days and internal projects, the remaining 70% result in 157.5 net working days which is the total capacity available to prepare and conduct the audit as well as to follow-up with the implementation progress.

In case of respondent A 472.5 working days are available in one calendar year to perform 13 audits. The average capacity available to conduct 1 of the 13 audits is therefore 36.35 working days. Participant B has 157.5 working days available to perform 6 audits which is an average capacity of 26.25 working days to conduct 1 audit. Assuming that CAF Company C carries out an average of 17.5 audits in one calendar year the available capacity is 315 working days. To carry out 1 of the 6 audits the available average capacity is 18 working days. Finally, participant D allocates a total capacity of 393.75 working days to perform 10 audits which results in an average capacity of 39.38 working days to carry out 1 audit.

		A	B	C	D
I	Number of audits carried out within the CAF Company per year	13	6+	15-20	10
II	Allocated man-years to carry out IA activities	3	1	2	2.5
III	Total capacity in working days available to perform all audits (=157.5 x II)	472.5	157.5	315	393.75
IV	Average capacity in working days available to perform one audit (=III / I)	36.35	26.25	18	39.75

**Table 6: Calculation of the allocated capacity to perform audits in the UK CAF Companies**

The answers concerning the audit structure of the *reporting line of the Head of the IA department* belonging to the CAF Company are the same for respondent B and C, the Head of IA in CAF Company B and C report into someone within the CAF Company. The Head of IA in CAF Company D reports administratively to someone within and functionally to someone outside the local financial services organisation. Participant A did not select any of the given options as this CAF Company has adopted the *Centralised model* where the IA department related to the group performs the internal audits and reporting lines are set up within the group.

	A	B	C	D
Head of IA reports into someone within the CAF Company (e.g. CEO, CFO)		x	x	
Head of IA reports into someone outside the CAF Company (e.g. Head of Corporate Audit worldwide)				
Head of IA reports administratively into someone within and functionally into someone outside the CAF Company				x

**Table 7: Reporting line of the Head of the IA departments belonging to the UK CAF Companies**

The findings of this survey concerning the audit structure and reporting line of the Head of the IA departments indicated that the UK companies have achieved the organisational independence requirements introduced by the IIA. The IIA International Standards state that IA functions should be free from interference in determining the scope of IA, performing work, and communicating the results. The Head of IA should report to a level within the organisation that allows the IA function to fulfil its responsibilities (IIA, 2004a). Respondent A has adopted the *Centralised model* that implies higher organisational independence of the IA from the local management of the CAF Company compared to e.g. *the Decentralised model*. It can be argued that the group's IA is considered as external to the local financial services organisation and Sawyer et al. (2003) highlights that IA not belonging to the organisation performs its activities more independently as it is not affected by internal politics or personal dependencies. The other respondents have adopted *Two-tier structure 3* and although the local IA department plans and performs activities autonomously, the group's IA department also carries out internal audits in the local financial services organisation. The group's IA department represents an external factor which exerts additional control over the independent functioning of the local IA department and the local management's activities.

These findings for the UK indicate that the respondents entirely report to a level of higher management, e.g. CEO or CFO, which allows the IA function to fulfil its responsibilities independently from operational departments. The higher degree of IA independence for respondent D is prominent when compared to the other respondents because the Head of the IA department reports only administratively to someone within and functionally to someone outside the local CAF Company.

The UK companies have chosen a structure that establishes an independent organisational status of their IA functions with clear reporting lines to a level of senior management. Accordingly, all the respondents comply with the FSA recommendations and display an independent status of the IA function through the adoption of the *Centralised model* or *Two-tier structure 3* with an appropriate reporting line for the Head of IA.

The results concerning the IA function's responsibility for carrying out activities in addition to the core activities (i.e. giving independent, objective assurance and consulting service) provided a varied picture of activities. The respondents included activities in addition to the pre-selected options which give an indication of their roles and responsibilities that meet with their specified job title. The options shaded in Table 8 were supplemented by the participants in their questionnaires.

	A	B	C	D
Compliance Officer		x		x
Money Laundering Officer			x	x
Key contact for regulatory authority		x		x
Accountability for RM or its processes		x		x
Accountability for IC or its processes				x
Attendance at industry working committee FLA				x
Support Sarbanes Oxley Act			x	
Data Protection Officer		x		
Information Security Officer		x		

**Table 8: IA function's responsibility to carry out activities in addition to the core IA activities of the UK CAF Companies**

The questionnaire received from CAF Company A was filled in by the Head of Corporate Audit UK and none of the additional responsibilities were selected. The other respondents indicated additional activities and the job title of respondent B is Head of

operational Risk & Internal Control, of respondent C Business Risk Manager and respondent D has the role of the Director of Risk & Internal Control. This indicates that the IA departments might be incorporated into the Risk and Control function of these CAF Companies and thus, activities in addition to the core IA activities are performed. The survey asked the respondents to specify the responsibility for activities in addition to the core activities of IA, the answers given by the UK Companies did not always conform to expectations based on the literature review. CAF Company A did not select any of the additional responsibilities whereas the other respondents indicated additional tasks and responsibilities. Only the IA function of respondent A is in line with the classification introduced by the IIA. The IA should not be accountable for risk management, the implementation of its processes or the managements' assurance on risks (IIA, 2004b). According to the findings of this survey the tasks and responsibilities the IA functions perform, it could be argued that CAF Company B and D do not fully adopt the 'Best Practice' approach introduced by the professional body IIA. Based on the findings of this survey it could therefore be assumed the IA functions are too closely involved in the risk and control activities of their financial services organisation. This might impair their independence for performing audits of these processes. This assumption is supported by the nature of the additional tasks and responsibilities noted. The specified job titles of the respondents who filled in the questionnaires also gave an indication of their roles and responsibilities and the positioning of the IA function within the company.

The results regarding the legal and regulatory requirements for IA functions provide interesting insights into the different attitude towards compliance, and as to whether it is mandatory or otherwise. Table 9 highlights the supplemented options (shaded) that were not pre-selected in the questionnaires.

	A		B		C		D	
	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless
Combined Code		x		x				x
FSA Handbook of Rules and Guidance	x		x					x
Financial Services and Market Act 2000			x					x
Basel Committee on Banking Supervision			x					x
Bank of France Regulations							x	
Data Protection Act					x			
AML/CTF Regulations					x			
Consumer Credit Act					x			

**Table 9: Distinction between legal and regulatory requirements for the IA functions of the UK CAF Companies**

CAF Company A and B indicated that the *FSA Handbook* is mandatory and the *Combined Code* is not mandatory but they comply nevertheless. The respondents B and D indicated that they comply with the *Framework for IC Systems in Banking Organisations* published by the Basel Committee on Banking Supervision. CAF Company D also complies with the *Bank of France Regulations* which is mandatory for their group. Although these CAF Companies do not have a banking licence in the UK the company group of respondent B has a universal banking licence and is regulated by the Dutch Bank. CAF Company D is part of a French bank and the respondent specified that the requirements of the Basel Committee on Banking Supervision are totally driven by their Head Office.

Respondent B indicated that it considered the *Data Protection Act*, *Anti-Money-Laundering and Counter-Terrorism-Finance Regulations* (AML/CTF) and the *Consumer Credit Act* as mandatory. These regulations are mandatory for CAF Companies in the UK; they do not have any implications for the audit structure, internal reporting lines or tasks and responsibilities for IA functions. Requirements for IA in the UK are mainly defined by recommendations which are not legally binding. The guidance and recommendations are commonly applied as ‘Best Practice’ approaches to IA which is also supported by the findings of this survey (Dewing and Russell, 2004). CAF Company A and B indicated that the *FSA Handbook* is mandatory and the *Combined Code* is not mandatory but they comply nevertheless.

The answers from respondent C and D differed as these are not listed on the UK stock exchange but authorised by the FSA. Nevertheless, the regulations indicated by the respondents C and D are mandatory for financial services organisations but do not affect the audit tasks, responsibilities, reporting lines and audit structure.

**CAF Companies in Russia**

When analysing the Russian market it has to be borne in mind Russia’s unique culture, and legal and regulatory framework. The recommendations of the Russian corporate governance code called FCSM Code exactly define the structure, task and responsibilities for the Control and Audit Service (CAS). The FCSM Code recommends



that the company should establish a structural subdivision of the organisation which needs to act independently of the executive bodies of the company and is responsible for continuous internal supervision. A general summary of the FCSM Code recommends that the CAS should develop policies and procedures for internal control in cooperation with the executive bodies and Audit Committee. The CAS is responsible for exercising daily control over the financial and business activities as well as examining documents regarding compliance of the company with its internal control procedures. In addition, CAS analyses, evaluates non-standard operations and prepares recommendations for the Supervisory Board. The FCSM Code recommends that at least 2/3 of the staff and the Head of the CAS should have a higher degree in the field of finance, accounting, business law or economics. The Head of the CAS should have at least five years experience in a similar function, while the Head's contract and that for all other employees must be signed by the Chairman of the Supervisory Board to protect the independence of the department (FCSM Code, 2002).

In general, most Western companies separate internal control and IA in terms of authority and organisation. Whereas the internal control function is commonly discharged by a control department on a daily basis, the IA function is carried out by an internal auditor on a regular basis. Russia seems to have adopted a hybrid model and the CAS takes on some duties which are typically carried out by the IA function but it functions on a daily basis as if it was a control department (IFC, 2004a).

A survey conducted by the IFC states that the Russian banking system

*“is still recovering from the 1998 financial crisis and slowly beginning to play a greater role in financial intermediation”* (IFC, 2004b, p.4).

The Russian banking sector is small on the global scale and further reforms are necessary to overcome present challenges through increased competition and capital requirements. The Central Bank of Russia (CBR) has been moving away from a reviewing approach to a more qualitative and prudential approach of assessing the financial conditions of banks and assuring the identification of problems before they become acute (IFC, 2004b). One measure of the CBR to increase customer protection after the financial crisis in 1998 was the tightening of regulatory requirements for banks to obtain the banking licence. A banking licence is necessary for CAF Companies in Russia to be able to offer financial services products, to conduct auto loan business and to offer current accounts to private and commercial customers. There have been

extensive improvements of regulations concerning the financial services sector which also influence the audit structure, internal reporting lines, tasks and responsibilities of IA functions (IFC, 2004b).

In an attempt at control, the CBR introduced the Regulation No. 242-P in 2003 which sets out the rules of internal control in credit institutions and banking groups as well as the way the CBR supervises compliance. This Regulation defines internal control and identifies responsible officers and the components required to establish an internal control service and its functions (Russian Microfinance Centre, 2004). Article 2.2.1 stipulates that the IA function (referred to as the service of Internal Control), a structural subdivision of a credit organisation should discharge internal control activities and is mandatory for credit organisations registered in Russia. The IA has to discharge its activities according to an internal document and carry out activities in line with the requirements set in Article 4 of the Regulation. Another body which is required to exercise internal control is the compliance officer who is responsible for the counteraction against the legalisation (laundering) of criminally received incomes and the financing of terrorism.

Regulation No. 242-P refers to the establishment of an internal document to define and regulate the activities of IA. This document defines the status of the IA in the organisation, and stipulates that the IA should be responsible for checking the efficiency and reliability of the processes and procedures for internal control as well as the monitoring of the internal control system. It should assist management in ensuring the effective functioning of the credit organisation and provide recommendations for the improvement of processes. The IA should discharge the traditional IA responsibilities of checking the reliability of accounting and reporting, safeguarding the credit organisation's property, assessing the economic expediency and efficiency of operations and ensuring compliance with internal documents and legal acts. Additional functions include the assessment of the risk management approach and the responsibility for submitting information and reports to the CBR. The assured constancy of the activity of the IA implies a permanent performance of this function within the credit organisation. A constant and permanent delivery of IA is a requirement with a proviso that the IA function is not that of an outside organisation. If specialists in this area of activity are unavailable, it may be possible to transfer the function of the IA to another credit organisation that is a member of the banking group. This Regulation also defines provisions which need to be implemented in order to ensure an independent as well as

impartial status of the IA. The IA should act under direct control of the Supervisory Board, not carry out activities liable to checking and be able to report at its own initiative on its findings and on proposals to solve issues identified. The information should also be disclosed to a sole or collective Executive Body of the credit organisation (e.g. General Director also referred to as the CEO or Management Board). Finally, this Regulation gives guidance on how to ensure the impartiality of the IA along with the required competences for its proper functioning.

The effectiveness of the Russian legal system is still relatively low due to complex structural organisation of the courts and their lack of independence. Despite considerable administrative and judicial reforms the ultimate goal of enhancing the overall effectiveness of the law has not yet been achieved (EBRD, 2006). The banking sector has experienced great improvements through extensive efforts made by the CBR and the government to push forward regulations concerning internal control and the implications for IA (IFC, 2004b).

All the responding CAF Companies in Russia have a banking licence and respondent E and F are set up as an ‘OOO’ which equals a limited liability company, whereas respondent G is set up as a ‘ZAO’ which equals a private limited company whose shares are distributed among a limited number of shareholders and not publicly traded. The fact that all the researched CAF Companies in Russia have obtained the banking licence indicates that this is a necessary prerequisite to be able to offer the following financial services products.

	E		F		G	
	own account	external provider	own account	external provider	own account	external provider
Vehicle Financing	x		x		x	
Vehicle Leasing			x			
Fleet Management						
Insurance			x			
Vehicle related Service Products						
Current Account					x	x
Savings Account						
Loans						
Mortgages						
Credit Cards						
Investment Services						

**Table 10: Summary of the financial services product categories offered by the Russian CAF Companies**

The survey results concerning the *number of employees* show that participants E and F have between 0 and 49 employees and participant G has between 100 and 249 employees.

The audit structure for respondents E and F is the *Two-tier structure 3* which means that the local IA department plans and performs activities autonomously and the group's IA department also carries out internal audits within their financial services organisation. Respondent G selected the *Two-tier structure 1* implying that the group's IA department co-ordinates all the local IA department's activities and also carries out audits within the local financial services organisation in Russia. The answers concerning their organisational structure are combined in table 11.

	<b>E</b>	<b>F</b>	<b>G</b>
Outsourcing model			
Centralised model			
Decentralised model			
Two-tier structure 1			<b>x</b>
Two-tier structure 2			
Two-tier structure 3	<b>x</b>	<b>x</b>	
Two-tier structure 4			

**Table 11: Predominant organisational structure of the Russian IA functions**

The *number of years* that the current IA structure has been in place is the same for all 3 respondents, namely 1 year (table 12). Respondent G has obtained the banking licence in June 2007 and has accomplished almost one and a half years of operations. Respondent E and F have obtained their banking licence in May 2008 and November 2007 and therefore are still at the opening stages of establishing the bank. The *number of audits carried out* within their financial services organisation varies slightly between respondent G who has obtained the banking licence a little earlier than respondent E and F. In addition, the company size of respondent G with respect to the number of employees is bigger than for E and F and may also have an effect on the number of audits carried out within the CAF Companies.

	<b>E</b>	<b>F</b>	<b>G</b>
Years of existence of the specified IA structure	<b>1</b>	<b>1</b>	<b>1</b>
Number of audits carried out within the CAF Company	<b>10</b>	<b>10</b>	<b>15</b>
Allocated man-years to carry out IA activities	<b>1</b>	<b>1</b>	<b>1</b>

**Table 12: Research results about the years of existence, number of audits and allocated man-years in the Russian CAF Companies**

The *allocated capacity to carry out IA activities* is 1 man-year for all respondents and assuming the same conditions as described in the UK comparison, the available capacity for respondent E and F to carry out 10 audits is 157.5 working days. This means that the IA functions of CAF Company E and F allocate an average capacity of 15.8 working days to perform 1 audit. In contrast, respondent G has allocated 157.5 working days to perform 15 audits in one calendar year which implies that CAF Company G has an average capacity of 10.5 working days to conduct 1 of the 15 audits.

		E	F	G
I	Number of audits carried out within the CAF Company per year	10	10	15
II	Allocated man-years to carry out IA activities	1	1	1
III	Total capacity in working days available to perform <b>all</b> audits (=157.5 x II)	157.5	157.5	157.5
IV	Average capacity in working days available to perform <b>one</b> audit (=III / I)	15.8	15.8	10.5

**Table 13: Calculation of the allocated capacity to perform audits in the Russian CAF Companies**

The audit structure for the *reporting line of the Head of IA* is the same for all the three respondents, as the Head of IA reports administratively to someone within and functionally to someone outside the financial services organisation. Participant E gave a more detailed explanation and stated that the Head of IA reports administratively to the Chief Executive Officer and functionally to the Supervisory Board of the local financial services organisation in accordance with the CBR requirements.

	E	F	G
Head of IA reports into someone within the CAF Company (e.g. CEO, CFO)			
Head of IA reports into someone outside the CAF Company (e.g. Head of Corporate Audit worldwide)			
Head of IA reports administratively into someone within and functionally into someone outside the CAF Company	x	x	x

**Table 14: Reporting line of the Head of the IA departments belonging to the Russian CAF Companies**

The findings of this research present a consistent compliance by the Russian respondents with the independence and reporting line requirements stipulated in the Regulation No. 242-P. The researched CAF Companies have adopted either *Two-tier structure 3 or 1* which supports the independent status of IA within the local financial services organisation but not necessarily from the local Executive Body. An additional reporting line into the Supervisory Board can ensure more independence e.g. compared to the UK where it is only required to report to a level of higher management such as CEO or CFO. Respondent E and G clearly stated in their questionnaires that the Head of IA reports administratively to the CEO and functionally to the Supervisory Board of the local financial services organisation which is in conformity with the Regulation No. 242-P. Furthermore, the findings confirm the status of the Supervisory Board in Russia as a mandatory control body, independent within the organisational structure and not involved in the management of a company's day-to-day activities. (IFC, 2004a).

Respondent G further highlighted the impact of their internal document on structural aspects in terms of the audit structure and reporting lines that supports the provisions defined in the Regulation No. 242-P concerning the necessity and content of the internal document.

The responses concerning the IA function's responsibility for carrying out activities in addition to the core activities of IA are consistent between the respondents. None of the participating CAF Companies indicated any roles and responsibilities in addition to the traditional objective assurance and consulting service of IA functions. These answers correspond with the determined tasks and responsibilities of IA functions in the financial services sector stipulated in the CBR Regulation No. 242-P/2003.

The responses support the expectations in that none of the respondents selected any activities which were outside core IA activities such as compliance officer work, money laundering, accountable for risk management or internal control design. Respondent G alluded to the content and the areas which are affected by their Regional IA Procedure which confirms the compliance with the provisions of the Regulation regarding the internal document.

Generally, the findings once again highlight that the Russian market is highly regulated as the tasks and responsibilities of CAF Companies in Russia are clearly defined in

Article 4.4 of the Regulation 242-P and the respondents consistently comply with the provisions.

The Russian financial services sector is highly regulated and controlled by the CBR and this is reflected in the findings of this survey. The responses regarding the legal and regulatory requirements for IA functions were consistent about the *Regulation No. 242-P* and indicated that this document is mandatory for all the researched CAF Companies in Russia. Respondent G gave a more detail explanation about the effects of this regulation on their financial services organisation and stated that this is the core document to be considered regarding the IA reporting lines structure (reporting to Supervisory Board on IA, findings and recommendations and administratively to the CEO). Furthermore, Respondent G highlighted that the *Regulation No. 242-P* has an effect on areas to be audited, audit plan and methods, documenting and reporting as well as types of controls, responsibility of management bodies and officers, and monitoring of internal controls (table 15 provides an overview of the answers).

	E		F		G	
	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless
FCSM CG Code						
Federal Law on "Banks and Banking Activities"	x					
Federal Law No. 115-FZ/201						
Regulation No. 242-P/2003	x		x		x	
Basel Committee on Banking Supervision		x				
Regional IA Procedure					x	

**Table 15: Distinction between legal and regulatory requirements for the Russian CAF Companies**

Respondent E specified that the *Federal Law on Banks and Banking Activities* is mandatory and the *Framework for Internal Control Systems in Banking Organisations* published by the Basel Committee on Banking Supervision is not mandatory for them but they comply with nevertheless. Respondent G clarified that the internal document referred to as *Regional IA Procedure* provides mandatory rules for the organisational set-up, reporting lines and the annual audit programme. This internal document of respondent G defines an additional reporting line to the regional IA director.

The extensive and clear regulation of IA for credit organisations in general is further underpinned by the indication of all respondents in the questionnaire that it is a mandatory obligation for their IA function to comply with the Regulation No. 242-P.

The acquisition of a banking licence is a prerequisite for CAF Companies to be able to offer loans, current accounts to private and commercial customers, and to be entitled to

conclude financing or leasing contracts (IFC, 2004b). The results of this survey are therefore in line with the legal and regulatory requirements of the Russian market to obtain a banking licence to be able to offer certain financial services products.

### **CAF Companies in Italy**

The enactment of the Law No. 262/2005 has improved the role of IA due to the perceived importance to management as support and assurance for information flow and risk identification (Cortesi and Tettamanzi, 2007). Law No. 262/2005 is mandatory for companies listed on the Italian stock market and

*“sets up stricter rules on corporate governance, addressing relations between banks and firms, penalties for the accounts falsification and compulsory information for companies issuing bonds”* (Arena and Maccarrone, 2007).

The importance of IA functions has also increased through the approval of the Legislative Decree 231 in 2001 regarding the administrative liability of companies, where

*“the company is liable for crimes committed in its interest or to its benefit by individuals who represent, administer or manage the Company”* (Miglietta et al., 2007, p.50).

The IA function in Italy is currently in an evolutionary phase in terms of tasks, responsibilities and relationships with other control bodies, this development has been supported by the new legal and regulatory changes recently introduced in Italy (Cortesi and Tettamanzi, 2007).

The regulation of corporate governance in the banking sector has been specified and enforced in more detail by the supervisory provisions concerning banks' organisation approved by the Bank of Italy in 2008. The Bank of Italy is the authority responsible for regulation and supervision of credit institutions and other financial intermediaries. The supervisory provisions introduced in 2008 implement the guidelines pertaining to banks and parent companies of banking groups stipulated in the so called Gazzetta Ufficiale No. 200 issued by the Ministry for the Economy in 2004. This decree defined general criteria and guidelines concerning the organisation and CG of banks, other financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking (Testo unico Bancario/Legislative Decree No. 358) and electronic money institutions (Bank of Italy, 2008).



The general approach of these supervisory provisions issued by the Bank of Italy is to give banks and parent companies of banking groups the flexibility to determine the best ways of applying these rules depending on their size, organisation and business characteristics. The rules establish a comprehensive regulatory framework which is aligned with the risks typical for banking and financial activities in order to provide a clear distinction of functions and division of powers and responsibilities. The supervisory provisions apply to banks and parent companies of banking groups who must verify that their governance arrangements comply with the new provisions and make any necessary adjustments by June 30, 2009 (Opromolla, 2008).

The regulation concerning the IA functions applicable to financial intermediaries entered in the special register, (referred to in Article 107 of the Consolidated Law on Banking), is in the supervisory instruction Circolare 216. The supervisory instruction delegates the responsibility for the periodical evaluation of the completeness, appropriateness and effectiveness of the internal control system to the IA function. It defines that internal audits should be conducted on a regular basis according to an agreed schedule that is consistent with the individual needs of a company, its size and activities, as well as the risks it faces. In addition, the IA should be independent from the operational departments and the activities reported regularly to the Board of Directors, management and Collegio Sindacale. The Circolare 216 also defines clear rules concerning the outsourcing of the IA in that it may be outsourced but management remains responsible for all the legal compliance and the Bank of Italy as the regulator requires ready access to the documentation retained by the external service provider. Any financial intermediaries who want to outsource the IA or other functions have to give notice to the Bank of Italy before completing the contract. This notice has to explain the reasons for adopting the outsourcing model, indicate how the external provider will operate and how it will be controlled by the outsourcer (Circolare, 2002).

A survey conducted by Allegrini and D'Onza (2003) revealed that financial institutions in Italy mainly establish IA departments to comply with regulatory requirements and that the role of IA has partly evolved from the previous role of compliance officer. Cortesi and Tettamanzi (2007) identify issues that presently limit the effectiveness of the IA's activities within Italian companies, and suggest that protection of the IA independence, an increase in the role and responsibility, and advanced penalty for incorrect behaviour are necessary to improve the current situation. They concluded that the recent law changes have already contributed to the improvement of the situation for

IA functions and helped to increase the relevance and perceptions of IA within Italian companies. Circolare 216 gives relatively vague instructions on the tasks and responsibilities IA functions should undertake. The supervisory instruction solely defines that the IA function is responsible for the periodical evaluation of the completeness, appropriateness and effectiveness of the internal control systems and internal audits should be conducted on a regular basis according to an agreed schedule (Circolare 216, 2002).

The responding CAF Companies in Italy are consistently set up as an S.p.A. which is a limited liability company that has the choice between trading the shares on the stock exchanges and not offering shares publicly. None of the participating CAF Companies of this survey trade shares publicly, and all have between 100 and 249 of employees. The respondents indicated that they do not have a banking licence which means that the financial services products offered and summarised in table 17 do not require such a licence.

	H		J	
	own account	external provider	own account	external provider
Vehicle Financing	x		x	
Vehicle Leasing	x		x	
Fleet Management	x			x
Insurance		x		x
Vehicle related Service Products		x		x
Current Account				
Savings Account				
Loans				
Mortgages				
Credit Cards				x
Investment Services				
Factoring	x			

**Table 16: Summary of the financial services product categories offered by the Italian CAF Companies**

Both respondents indicated that the local IA department plans and performs activities autonomously and the group's IA department also carries out audits within the local financial services organisation. This audit structure equals the *Two-tier structure 3* listed in the questionnaire. The answers of both Italian CAF Companies were also identical with regard to the *reporting line of the Head of IA*. Respondent H and J stated

that their Head of IA reports to someone within the financial services organisation (e.g. CEO, CFO).

The current IA structure has been in place for 4 years for CAF Company H and 5 years for CAF Company J, however in terms of the *number of audits carried out* within their financials services there is a major difference between the respondents. CAF Company H indicated an average of 28 audits per year and further explained that there are no fixed days behind an audit and it depends on the areas or topics to be audited. CAF Company J specifies an average of only 8 audits to be carried out within one year. Another very interesting result of this survey is that both allocate almost the same amount of *man-years to carry out the IA activities* despite a significantly deviation in the number of audits. Accordingly, the allocated capacity of respondent H to carry out 28 audits is 1 man-year and of respondent J 1.5 man-years to carry out 8 audits. This implies that CAF Company J allocates more man-years to conduct 8 audits than CAF Company H to conduct 28 audits.

	H	J
Years of existence of the specified IA model	4	5
Number of audits carried out within the CAF Company	28	8
Allocated man-years to carry out IA activities	1	1.5

**Table 17: Research results about the years of existence, number of audits and allocated man-years in the Italian CAF Companies**

The calculation of the *average capacity in working days* available to perform audit activities in the Italian CAF Companies assumes the same conditions as described for the UK CAF Companies. Participant H has allocated 1 man-year to carry out IA activities equalling a capacity of 157.5 working days available to perform all the 28 audits. The IA function of respondent H allocates an average capacity of 5.63 working days to perform 1 audit. Participant J calculates a capacity of 1.5 man-years to perform 8 audits which implies an average capacity of 29.53 working days to conduct 1 of the 8 audits.

		H	J
<b>I</b>	Number of audits carried out within the CAF Company per year	28	8
<b>II</b>	Allocated man-years to carry out IA activities	1	1.5
<b>III</b>	Total capacity in working days available to perform all audits (=157.5 x II)	157.5	236.25
<b>IV</b>	Average capacity in working days available to perform one audit (=III / I)	5.63	29.53

**Table 18: Calculation of the allocated capacity to perform audits in the Italian CAF Companies**

The regulation of IA applicable to financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking is presently just covered in the supervisory instruction Circolare 216. The Circolare 216 published by the Bank of Italy defines that IA should be independent from the operational departments and the IA activities should be reported regularly to the Board of Director, management and Collegio Sindacale (Circolare 216, 2002).

The independence and reporting line requirements are implemented in both cases. Italian CAF Companies indicated that they have a *Two-tier structure 3* and operate reporting lines to someone within the financial services organisation (e.g. CEO, CFO) which complies with the instructions of Circolare 216. A reporting line to the Board of Directors or the Collegio Sindacale was not particularly specified.

The responses about the IA function's responsibility for carrying out activities in addition to the core activities presented a wider scope of accountability for the IA functions of the Italian CAF Companies than outlined by the IIA Best Practice recommendations (IIA, 2004a). Both of the respondents take the role of the *Compliance Officer* and *Key contact for regulatory authority* and only respondent J indicated *Money Laundering Officer* as an additional responsibility. In addition, respondent H is responsible for the monthly and quarterly *reporting to the Bank of Italy* and the *coordination with external lawyers* about contractual aspects. These options were not pre-selected in the questionnaires and are therefore shaded in the table below.

	<b>H</b>	<b>J</b>
Compliance Officer	<b>x</b>	<b>x</b>
Money Laundering Officer		<b>x</b>
Key contact for regulatory authority	<b>x</b>	<b>x</b>
Accountability for RM or its processes		
Accountability for IC or its processes		
Reporting activities to Bank of Italy	<b>x</b>	
Coordination with external lawyers	<b>x</b>	

**Table 19: IA function's responsibility to carry out activities in addition to the core IA activities of the Italian CAF Companies**

The Italian companies presented a wider scope of activities carried out by the IA functions than envisioned by the IIA Best Practice recommendations. The responsibility for taking over the role of the Compliance or Money Laundering Officer is normally not allocated in the area of accountability for IA but these activities were selected by the Italian respondents (IIA, 2004a). Comparing the results from this survey with the findings from a survey conducted by Allegrini and D'Onza (2003) corresponding aspects can be identified. The survey concluded that in smaller companies internal auditors are still perceived as an inspector, mainly performing traditional assurance activities and compliance audits. These aspects are also reflected in the additional activities selected and supplemented in the questionnaires of the Italian respondents who are both smaller companies with a number of employees between 100 and 249. , Allegrini and D'Onza (2003, p. 192) state,

*“in financial institutions, internal auditors usually assert to participate in the risk management team and to provide some contribution in the qualitative assessment of operational risks”.*

This aspect is also supported through the findings of this survey as the questionnaires were filled in by the Risk Management Specialist of CAF Company A and the Direttore clienti e rischio of CAF Company J. The job titles of the respondents give an indication about the organisational incorporation of the IA function into the risk management function and the additional activities selected in the questionnaires further support this assumption.

In term of the legal and regulatory requirements for IA functions highlighted the different perceptions of the responding CAF Companies about the obligation to comply with the selected regulations. Both respondents indicated the *Legislative Decree No. 358* also referred to as the Consolidated Law on Banking as not mandatory but they comply nevertheless. Both CAF Companies selected the *Legislative Decree No. 231* whereas respondent H considers this regulation to be mandatory while respondent J sees it as not mandatory but complies nevertheless. Finally, a major difference between the answers received from the Italian CAF Companies is their perception of the *Supervisory Instructions Circolare 216*, only respondent H indicated the instruction as mandatory. Although both CAF Companies have to be entered in the special register due to the financial services products they offer respondent J did not select any options given in the questionnaire for the Supervisory Instructions Circolare 216. The table below summarises the answers received from the two companies.

	H		J	
	mandatory	not mandatory but comply with nevertheless	mandatory	not mandatory but comply with nevertheless
Preda Code				
Legislative Decree No. 358/1993 (TUB)		x		x
Legislative Decree No. 58/1993 (Draghi's Law)				
Legislative Decree No. 231/2001	x			x
Supervisory Instructions Circolare 216/1996	x			
Law No. 262/2005 (Legge Risparmio)				
Gazzetta Ufficiale No. 200/2004				
Basel Committee on Banking Supervision				

**Table 20: Distinction between legal and regulatory requirements for the Italian CAF Companies**

These responses from Italian CAF Companies were not completely consistent as regards to adherence to the identified regulations, recommendations and guidelines. This might be a consequence of the recently introduced legal and regulatory changes and the current evolutionary status of IA concerning their tasks, responsibilities and relationships with other control bodies (Cortesi and Tettamanzi, 2007).

The answer of CAF Company H is in line with Legislative Decree No. 231, this law applies to all companies in Italy and addresses the administrative liability of companies for crimes committed in its interest or to its benefit by individuals who represent, administer or manage the company. This law significantly increased the importance of IA as well as organisational, management and control models as companies in Italy are exempt from liability for crimes specified in Law 231/2001 if they have adopted and effectively implemented appropriate control models to avoid the crimes (Miglietta et al., 2007). Both respondents offer financial services products which require the registration in the special register only company H specified the Circolare 216 to be mandatory.

None of the responding CAF Companies selected the supervisory provisions implementing the decree Gazzetta Ufficiale No. 200 concerning banks' organisation and corporate governance mandatory for banks and parent companies of banking groups (Opromolla, 2008). Neither company has obtained a banking licence and the supervisory provisions are therefore not applicable to them.

## **Interdependences and Relationships between the Research Results**

The comparison of the research findings for each country and respondent concerning the allocated average capacity to perform one audit indicated individual audit requirements for the researched CAF Companies amongst the countries but also within the same country. The average capacity in working days available to perform one audit varied from 18 to 39.75 working days in the UK. A major difference between the average capacity to perform one audit was identified in Italy where CAF Company H allocates 5.63 and J 29.53 working days. The most corresponding results were found in Russia where the researched CAF Companies E and F spend 15.8 and G 10.5 working days on average to perform one audit. The average capacity allocated to perform one audit may vary because of different company sizes, structures, processes and products which are offered and the effects this individual audit structure may have on the complexity of the company and the risks it is exposed to (Pickett, 2005).

This survey highlights the more specific and rigid the regulation of the country concerning IA activities, the more similar and corresponding is the average capacity allocated to perform one audit. The relationship between more detailed regulation of IA activities and a consistent allocation of average capacity to perform one audit was identified for the Russian CAF Companies within this survey. The more flexible the regulation in the researched country and the more room for individual implementation for IA is given; a greater deviation exists in the allocated capacity to perform audits (as indicated by the results of the UK and Italy). According to the research findings it could be argued that the more clearly stipulated the IA activities, the more similar the audit scope and intensity and thereby, the allocated average capacity per audit. The research findings show a relationship between more detailed and rigid regulations of IA activities and a consistent allocation of average capacity per audit. The relationship between more detailed IA regulation and more consistent answers of the researched CAF Companies was also recognized with regard to the IA function's responsibility for carrying out activities in addition to the core activities. In Russia, the country with the most specific and rigid regulation for IA, none of the respondents selected additional activities which is in line with the Russian Regulation No. 242-P and the IIA Best Practices recommendations. Most of the researched CAF Companies in the UK and Italy selected additional activities such as accountability for risk management and internal control and its processes or the role of the Compliance and Money Laundering Officer. The research

results highlight that the absence of specific regulation tends to increase the deviation of IA function's activities from IIA Best Practice approaches. This might be a consequence of the increased flexibility created through non-binding recommendations to implement IA functions and their activities. It could be argued that IA functions are more involved in non-core IA activities if the regulation enables a more flexible implementation of IA because of the individual interpretation of recommendations and the absence of mandatory obligations. Overall, the research results highlight interdependences between more detailed and rigid regulation of IA and the degree of compliance with IIA Best Practice approaches.

The results also indicated that the younger the IA structure, the fewer activities are performed in addition to the traditional IA activities. The IA structure of the three Russian companies have only been in existence for 1 year and do not undertake any activities in addition to the IA activities defined in Regulation No. 242-P which are in line with the IIA Best Practice recommendations. Company C in the UK has been in existence only for 2 years and carries out two additional activities. The remaining UK respondents except one and all the Italian companies have been established for more than 4 years and perform several activities in addition to the core IA activities. These results highlight an increased tendency to comply with the IIA Best Practice recommendations by IA departments established within the last 4 years even in the researched countries with less specific IA regulation. It could be argued that the perception of IA functions in the researched countries to comply with IIA Best Practice recommendations has increased in recent years. This development could reflect the overall increased importance of good governance in the twenty-first century due to a number of large corporate scandals and failures which negatively affected shareholders' trust. It places IA as a valuable source of information and assurance increasing its importance regain shareholders' trust (Fernandez-Laviada, 2007). Finally, the research indicates a relationship between the detail of regulation concerning the reporting lines and the level of independence of IA functions within financial services organisations. The research results have shown that in Russia where the regulation clearly defines that the Head of IA should report administratively to the CEO but functionally to the Supervisory Board which is not involved in day-to-day activities, all the Russian respondents have established additional reporting lines to someone outside the CAF Company. In contrast, in the UK and Italy where it is only recommended to have a reporting line to the board, audit committee, senior management (and for Italy



additionally to the Collegio Sindacale), most of the respondents have only implemented a reporting line into someone within the CAF Company. The Russian company IA functions have consistently obtained the highest level of independence compared to the other research country participants. Therefore, it could be argued that the more detailed the regulation stipulates the reporting lines to someone outside the financial services organisation, the more consistent and independent are the implemented reporting lines of the IA functions.

## **Conclusions**

The findings of this survey were in many instances in line with the issues expected in terms of the 'Best Practice' approach. The independent status of the IA functions and therefore, the implemented audit structures, and reporting lines within the researched CAF Companies in the specified countries, consistently complied with their legal and regulatory frameworks. Deviations from the expected practice came from the UK and Italy where the IA carried out additional activities to the core ones. Most of the instances where additional activities were selected, the IA function was more closely involved and partly assumed to be accountable for the risk management activities of their financial services organisation. This assumption was supported by the nature of the additional tasks and responsibilities which were selected and the indicated job titles of the respondents who completed the questionnaires. A comparison of the results also contributed to the identification of interdependences and relationships that impacted on the establishment of a framework for an effective IA function. The more detailed the regulation of IA activities and a consistent allocation of average capacity to perform one audit was identified in the Russian CAF Companies. Confirming the argument that the more clearly stipulated the IA activities, the more similar the audit scope and intensity must be and thereby, the allocated average capacity per audit.

The research results of the UK and Italy indicated the interdependence between that the absence of mandatory obligations and the flexibility to interpret recommendations individually leads to greater involvement of IA in non-core activities. In general, the results pointed out that the specification of activities IA functions should (or equally should not) discharge as stated by the regulators of each research country is relatively vague. A general guidance of what IA functions should do is given by the IIA International Standards and position papers published by the ECIIA (2005) to define the scope and types of IA activities. Even in Russia where IA activities are more precisely

defined than in the other countries examined in this research, the reviewed legal and regulatory frameworks do not clearly stipulate IA activities.

In terms of the level of independence of the IA function, Russia consistently obtained the highest level of independence in its reporting line to someone outside the financial services organisation. It is clear that the more detailed the regulation stipulates the reporting lines the more consistent and independent are the implemented reporting lines of the IA functions. The Russian regulation concerning the organisational independence and reporting line requirements for CAF Companies is more detailed than the IIA International Standards. The Regulation No. 242-P stipulates that credit organisations should define the status of the IA in the organisational structure in an internal document. Furthermore, the credit organisations should be obliged to ensure the constancy of the activity and an impartial as well as independent status of the service of internal control. Therefore, to ensure the independent status of the IA, the Regulation defines a reporting line to the Supervisory Board and a sole or collective Executive Body of the credit organisation (e.g. General Director, also referred to as the CEO, or Management Board) (Regulation No. 242-P, 2003).

Overall, it can be concluded that Russia is the most regulated country with regard to IA functions of CAF Companies. The Russian legal and regulatory framework provides mandatory requirements for IA functions of CAF Companies which simultaneously supports the compliance with IIA Best Practice approaches. In contrast, the role and status of IA in Italy is in an evolutionary phase as seen from the individual responses from the Italian CAF Companies, and where mandatory obligations for IA functions of CAF Companies in Italy is still relatively undefined. Recent legal and regulatory changes are contributing to improve the situation for Italian IA functions that will help increase IA perceptions within Italian companies. For the UK it can be concluded that it is the country with the most extensive presence of recommendations and guidelines for IA, (the Combined Code and the FSA Handbook) particularly for IA functions of CAF Companies in addition to the IIA International Standards. The regulation of IA functions of CAF Companies is less binding and gives more flexibility to implement recommendations as compared to Russia. The four UK CAF Companies acknowledge the importance of IA and consistently implement the function despite any missing mandatory obligations. Due to the flexibility given by recommendations, the tasks and responsibilities performed by the IA functions of the UK CAF Companies did not

always comply with the Best Practice approaches introduced by the IIA. The flexibility of interpreting recommendations was also reflected in the different levels of independence achieved through the reporting lines of the IA functions of CAF Companies in the UK.

### **Limitations of this research**

The response rate was relatively small compared to the number of IA departments in CAF Companies. Nonetheless, the number of participants was sufficient to provide data to identify certain interdependencies and relationships. A limitation of this study was associated with the selected survey strategy for this research. The data collection techniques belonging to the survey strategy such as questionnaires had the disadvantage of making the research dependent on others for information which often resulted in a delay in the research output.

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