

European Governance

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Remixing Regulation

Banking supervisors want internal audit to play a more central role within bank regulation

INSIDE: Raising public sector control standards, helping directors to improve, corporate governance citizens and more



Getting heard

In February 2012, the European Commission (Budget DG) for the first time published the Compendium of the public internal control systems in the EU Member States 2012. This provided a structured overview of the various public internal control (PIC) systems currently being applied by the public sector in each of the 27 EU Member States.

The paper presents the so-called PIFC concept, which is a model for public internal control aligned with international standards such as INTOSAI and IIA IPPF, and European good practice. It can be used by the Commission

to provide potential candidate countries with guidance for re-engineering their public internal control systems where necessary.

“We heartily agree with the European Commission’s objectives to analyse PIC systems as a valuable way of developing benchmarking tools for identifying control frameworks for the proper and efficient management of public resources,” said ECIIA president Carolyn Dittmeier.

The topic was subject to much discussion at the conference on Public Internal Control systems in EU Member States that took place in Brussels in February 2012.

The debate in the public sector, be it at national level or at EU level, is about how to solve the sovereign debt and Euro crises. The conference heard that deficiencies in the functioning of public internal control were one the many causes of these problems.

Managerial accountability structures and internal control frameworks are key governance factors determining the quality and effectiveness of the public sector in managing national budgets, so it is important to get them right.

See this website for both the compendium and for conference slides.

certifications of IIA Global, IT risks and controls and more.

ECIIA and IIA Azerbaijan is hosting a conference, “Internal audit: realities and perspectives” in May 3-4, 2012 in Baku.

To attend, click here.

There are also events soon in **Slovenia** and **Norway**.

Events

IIA Bosnia and Herzegovina is organising the 7th International Conference of Internal Auditors for Central and Southeastern Europe between 10-12 May, 2012 in Sarajevo, Bosnia and Herzegovina.

For the program, click here.

IIA Bulgaria is hosting its

Fourth Professional Internal Auditor Conference

in Sofia, Bulgaria. The event, “The New Realities in Internal Audit”, takes place at The Sheraton Hotel Balkan, Sofia between 26-27 June, 2012. Presentations will include: The imminent revision of the Standards, updated COSO framework, the new

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Supporting best practice

Leading organisations in Europe are becoming increasingly aware that they need to pool their expertise if they are to meet the challenge of achieving sound corporate governance practice in a changing world.

The ECIIA is delighted to have welcomed Generali Group to its Corporate Governance Citizenship Programme. The business joins Enel and Eni in helping the ECIIA promote best corporate governance practice across Europe.

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To become a member, please see our website www.eciia.eu or contact us at corporate.governance@eciia.eu



Public standards

The Chartered Institute of Public Finance and Accountancy (CIPFA) and the Chartered Institute of Internal Auditors (IIA) jointly launched the UK Internal Audit Standards Advisory Board (IASAB) in March 2012. Internal audit standard setters aim to develop UK-wide Public Sector Internal Audit Standards (PSIAS). The IASAB will provide oversight and challenge for this process.

The new unified set of internal audit standards will be based on the mandatory elements of the IIA's International Professional Practices Framework, and it is proposed that they will apply across the UK to central and local government and the NHS (excluding foundation trusts). Other sectors and jurisdictions will be able to adopt PSIAS if they choose, and health sector regulator Monitor, the Government of the Republic of Ireland and the European Union have also nominated Board observers.

Janet Eilbeck was appointed independent chair of the IASAB.

She was assurance partner at PwC until 2011, specialising in government and the broader public sector, including wide experience of internal audit.

Meanwhile, Pascal Hallez, who leads one of the European Commission's Internal Audit Service units, says that the function has widened its remit. The IAS is increasingly auditing

services or agencies directly involved in the management and delivery of major infrastructural programmes in addition to its more usual role of reviewing whether financial EU contributions were spent according to sound financial management principles and in compliance with the rules.

The infrastructural programmes are likely to consist

of pan-European IT systems, research platforms or even space programmes. They may concern any policy: energy supply, transport, customs controls, immigration, food safety, nuclear security, pandemic management, carbon-quota management and many others.

You can read more about the IAS's role, here.

Last chance for early-bird conference discount



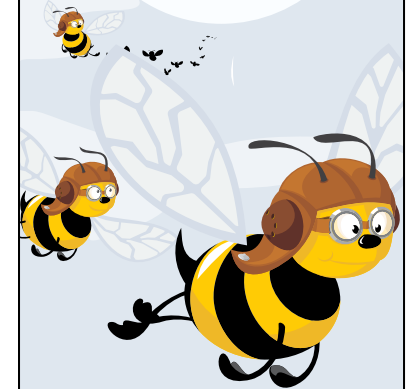
If you want to take advantage of the early-bird discount offer on the ECIIA's European Conference 2012, you need to act fast. Places at the

conference are available at a discount of €200 for delegates who book before May 1 – that's a 16% saving on the cost for members.

The conference, hosted by IIA Netherlands, takes place in Amsterdam on September 12-14. This year, the conference is designed to be highly interactive, so delegates can get more involved in the proceedings.

For those who miss the early-bird discount, registration will cost €1,250 for members and €1,450 non-members. There is a special group rate of €950 per person for bookings of ten or more delegates – but please note that the early-bird discount does not apply.

For more information:
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Remixing regulation

Banking supervisors want internal audit to play a more central role within bank regulation, as Arthur Piper reports

Internal auditors are set to play a more integral role in ensuring sound corporate governance in banks if proposals set out in the most recent guidance by the Basel Committee on Banking Supervision are rubber-stamped. The document, *The internal audit function in banks*, sets out principles aimed at enhancing internal audit's effectiveness and covers everything from the role of the auditor to the function's relationship with the regulators.

While internal audit was seldom directly implicated as the cause

of the banking crisis in 2007 and afterwards, the profession has subsequently considered what role it might be able to play in order to prevent such future catastrophes. The document represents the first comprehensive overhaul of thinking on internal audit by the Committee since its 2001 paper, *Internal audit in banks and the supervisor's relationship with auditors*.

So what's new? The Committee has taken a stronger stance on the independence of the internal audit function in several of its principles. For example, principle two states: "The bank's internal audit »



“The internal audit function is meant to provide global assurance to the board on the internal control and risk management systems pertaining to all governance objectives”

» function must be independent of the audited activities. This requires that the internal audit function has an appropriate standing within the bank, enabling internal auditors to carry out their assignments with objectivity.”

In addition, principle ten says that the audit committee – or the bank’s equivalent – should be responsible for overseeing the internal audit function; and that it should report to both the non-executive and executive boards.

Principles six and seven underline the broad, potential scope of audit work, so that internal auditors following the proposed guidance would cover “every activity (including outsourced activities) and every entity of the bank,” including its regulatory responsibilities.

Welcome

“A lot’s happened over the past ten years both in the banking sector and in the professionalisation of internal audit,” says ECIIA president Carolyn Dittmeier, who worked with Global IIA on the profession’s official response. “So, we welcome this document on supervisory guidance and the effectiveness of internal audit in banks.”

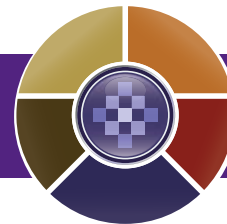
While broadly positive, the IIA’s response has called for clarification in some of the Committee’s principles. In particular, the excessive attention to regulatory surveillance rather than global assurance could be construed as potentially restricting the overall responsibilities of the internal audit function, especially given that the Compliance function has been »



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» reinforced just for this cause. In his letter to the Basel Committee, Richard Chambers, Global IIA's chairman, said: "With regard to its assurance role to the board, the internal audit function is meant to provide global assurance to the board on the internal control and risk management systems pertaining to all governance objectives. This encompasses business control objectives, financial reliability, regulatory and legal compliance, etc."

Principle five recommends that each bank has an internal audit charter that "articulates the purpose, standing and authority of the internal audit function within the bank". Chambers wrote that there should be guidance on the minimum requirements for an internal audit charter. He suggested that internal auditors should at least, provide information about evolving models on governance, risk, control and compliance (GRCC) to board members promote education of bank personnel on GRCC to ensure awareness and importance, and attend the bank's governance committee meetings to provide

advice and counsel. In order to maintain its independence, internal audit should act as an advisor and not have responsibility for the committee's work. It should also perform and report on fraud analysis and conduct special verification of potential irregularities.

Tools

"The internal audit profession has developed a lot of tools to help banks achieve good governance," says Dittmeier, "which was why we also recommended that the Committee enshrine the IIA's Code of Ethics and its International Standards for the Professional Practice of Internal Auditing into its principles. That way, we know that everyone is singing off the same hymn sheet."

"The proposals recognise that internal auditors must be given an enhanced status and standing within the banking sector and can play a greater part in avoiding another banking crisis," says Ian Peters, chief executive of the Chartered Institute of Internal Auditors in the UK and Ireland. "The Basel

consultation is addressing some of the issues that constrained the internal audit function in banks before the credit crunch."

Peters says that the UK and Ireland Institute emphasised the benefits of a risk-based approach to internal auditing in its own official response to the Basel Committee, rather than any regime that would enable the regulators to prescribe the scope and direction of the function's activities. He says this would allow internal auditors to focus on the risks they judged to be of greatest significance

"The internal audit profession has developed a lot of tools to help banks achieve good governance"

at any one time. "We want to ensure the balance is effective so that it produces the outcome that we all wish to see - better management of risks," he says.

The IIA reinforced this concept in the letter written by Chambers: "The head of internal audit is responsible for developing an

annual risk-based internal audit plan that can be part of a multi-year plan." He wrote to the Committee: "The head of internal audit takes into account audit risk factors as well as the bank's risk organisational objectives and risk management framework, including using risk appetite levels set by management for the different activities or parts of the organisation. If the framework does not exist, the head of internal audit will consider perceived risks on the basis of consultation with senior management."

Banks' response

The banks have also given a guarded welcome to the proposals, but want to ensure that they are workable in practice. For example, the European Association of Public Banks and Funding Agencies wrote to the Committee to say that some of its principles may

clash with existing regulations.

"The consultation paper shows that there is a need for harmonisation in respect of the scope of activity of all banks since this scope is fundamentally different from the regulations that apply in national regulations," it said. "Certain sections of the proposed provisions in the consultation paper are in conflict with the legally foreseen powers of senior management and the tasks of the board of directors in subsidiaries."

One of the potential areas of conflict that arises under the Committee's proposed system is the role of internal audit and the regulators. How far is internal audit to be an arm for the regulator and how far is it an independent function within the bank aimed at ensuring good governance practice? The question drew intense debate from participants at the ECIIA's conference in Madrid in 2011 and is still causing concern in the financial sector.

"The internal audit function's assurance and advisory role to management must not be undermined by supervisory »

“The internal audit function’s assurance and advisory role to management must not be undermined by supervisory authorities’ requests for information”

» authorities’ requests for information,” said the European Association of Public Banks and Funding Agencies. “There is a need to clearly define reporting and responsibility lines for the internal audit function.”

The issue arises because the consultative document explicitly recognises the role of the three lines of defence model and deals in detail with the relationship of internal audit, compliance and risk management. Although the Committee’s 2001 paper recognised reliance on the work of other departments this was only done in a limited way.

In the current version, the relationship between supervisors

and internal audit has been significantly expanded. In particular, more attention is paid to the way these groups communicate, particularly when it comes to sharing of information. Importantly, the proposals recognise that this is a two-way relationship and that supervisory authorities should consider sharing relevant information with internal audit (Principle sixteen). This lack of interaction was at the heart of the recent financial crisis.

Getting the wording in the final document will be critical because what is at stake is better governance in the banking sector and the chance to reduce the risk of another major banking crisis in future. ■

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Helping directors to improve

Board directors across Europe are keen to know more about corporate governance and assurance, the head of Ecoda tells Neil Baker

If Europe is going to find a path back to steady economic growth, it needs a confident and optimistic corporate sector. But there's an air of discontent inside many of the continent's boardrooms. Sir Martin Sorrell, chief executive of global advertising giant WPP, caught the mood in a recent article for a British newspaper. People were rightly angry about behaviour in the banking industry, he wrote, but politicians were engaging in "indiscriminate business bashing" in the belief it would win them votes.

Not only was it unfair to tar all business leaders with the same brush, it was counter-productive, Sorrell argued. A "cowed and hobbled" business sector would not create economic growth, jobs or tax revenues. If politicians didn't change their line of attack, "The alternatives will be to invest and

go elsewhere," warned Sorrell.

The new-found willingness of politicians to involve themselves in complex business affairs – not least corporate governance – is something that concerns Patrick Zurstrassen, chairman of the European Confederation of Directors' Associations (Ecoda), »

“There is a need for directors to understand governance better, from a higher viewpoint, and they are eager for this knowledge”



Head of Ecoda,
Patrick Zurstrassen

» a body that represents many of Europe's leading professional bodies for board directors.

There has long been a tendency in the media to criticise corporate leaders, Zurstrassen notes. Typical charges are that they put their own interests ahead of other stakeholders, pay themselves stunning rewards for mediocre performance, and only recruit board members

“We are concerned about the risk of an over-reaction on the regulatory front and the politicisation of some issues”

who are just like them. Non-executive directors, too, have been attacked, usually for failing to challenge senior executives.

In the wake of the financial crisis, politicians across Europe, from all ideological hues, have seen votes in this debate. Corporate governance issues such as executive pay, gender equality in the boardroom, and the number of posts a single

director can hold, have all become issues where national parliaments, regulators and the European Commission have all seen fit to become involved.

The problem, says Zurstrassen, is that corporate governance is a complex and nuanced area. “We are concerned about the risk of an over-reaction on the regulatory front and the politicisation of some issues,” he says. “We

have to accept that we work in a society where some business issues have a political nature and need to be dealt with by the political system, but we prefer the exercise of freedom.”

Zurstrassen draws a distinction between a social issue such as gender equality – where he does accept that political action may be appropriate, although it is not something Ecoda advocates –

and a governance issue such as the number of posts a director can hold. Consequently, he does not support legislation – such as that introduced in France and Belgium and considered at a European level for financial firms – that puts a fixed limit on the number of posts one director can hold. “That is an obvious over-reaction,” he says.

The amount of time required to be an effective director will vary from one company to another, Zurstrassen argues: “Whether a person can make sufficient commitment to be a director should be decided at the level of every board.”

Regulators or professional bodies might want to issue guidance on the topic, but it should be for boards to decide what action best suits their business.

Zurstrassen's wider concern is that the willingness of politicians and regulators to dictate boardroom behaviour might deter experienced business people from becoming board directors. He has already noticed that not enough people from audit and legal

Three lines of defence

The three lines of defence model explains how the various people involved in an organisation's risk management efforts should work together.

The first line of defence is operational managers. They are responsible for assessing, controlling and mitigating risks. The second line of defence is the specialist departments in the business – such as risk management and compliance. Their role is to help managers follow good risk management practices and to ensure they report the right risk-related information up and down the organisation.

The internal audit function is the third line of defence. Its role is to provide assurance to the organisation's governing body and senior management about how well the organization is assessing and managing risks, including how well the other two lines of defence are operating.

backgrounds are interested in the idea of taking a seat on a board. “Due to the crisis, directorship might not have the professional appeal it had in the past,” he says. “But, as a professional body, we have to fight and keep attracting people to the role.”

There is already a trend for directors to specialise in increasingly narrow business areas, he says. The governance

rules and expectations in the financial sector in particular are becoming more detailed and rules-based, he argues. This trend isn't entirely negative – if financial firms are working within a governance model that is more tailored to their needs, that is a good thing, Zurstrassen believes. “These businesses work in a different regulatory framework and have different social »

About Ecoda

The European Confederation of Directors' Associations is a not-for-profit association based in Brussels. It was founded in December 2004 and represents ten national director associations, including the British Institute of Directors, the Belgian Guberna and the French Institut Français des Administrateurs. Its mission is to promote corporate governance at large, to promote the role of directors towards shareholders and corporate stakeholders, and to promote the success of its national institutes.

For more information: www.ecoda.org

» responsibilities, so governance needs to be done differently.”

But it does mean that new directors need more time to get up to speed, and it can deter those from outside the sector – who can bring valuable and diverse business experience – from becoming involved. However, the core principles of what the board is for, and what makes a director effective – providing oversight, transparency and a balance of interests – apply across industry sectors, Zurstrassen argues.

The European Commission has several governance-related initiatives in the pipeline – on

pay and diversity – and these would introduce a level of consistency across Europe, when and if they are adopted into national laws or codes of practice. But in the meantime, increased national-level political and regulatory action is creating more of a patchwork approach to governance across Europe.

This is not necessarily a concern, says Zurstrassen. The European Commission long ago ruled out the idea of trying to create a pan-European corporate governance code. Differences in company law and business culture would make that impossible, Zurstrassen says. But

it does make life more difficult for board directors at companies that operate across borders, or that need to understand what good governance looks like in other parts of Europe.

Since 2010, Ecoda has run professional training courses to help directors to deal with this challenge. The aim is to help participants benchmark their own board and governance practices with those of similar companies in other European countries. The courses also provide an expert briefing on the key policy issues and regulatory changes in European corporate governance. “The programme has been very successful,” says Zurstrassen. “We’ve had people coming from all countries, learning from each other and sharing their experiences.” Ecoda is looking at extending the programme next year.

The success of the programme reflects the fact that directors across Europe are taking a more professional view of their role, and are eager for training opportunities, Zurstrassen says. Whenever one of Ecoda’s national

members launches a training initiative aimed at directors, “the demand has always been higher than the supply,” he says. “There is a need for directors to understand governance better, from a higher viewpoint, and they are eager for this knowledge. We don’t know the limits, the depths of demand. But we know that whenever we provide more supply, the demand is there.”

Europe needs better trained and more informed directors, Zurstrassen says, and Ecoda has an important role to play in that regard. It has already produced guidance for directors of unlisted companies and for audit committee members.

One of its next projects is a joint initiative with the ECIIA. The goal is to provide guidance for directors on the “three

lines of defence” model of risk management and internal control (see sidebar). This will be especially useful to audit committee members, which is a priority, says Zurstrassen.

The European Commission’s forthcoming governance directive is likely to say more about the technical knowledge expected of directors who sit on audit committees. “Not all directors have a background in auditing or finance, so we want to help them with guidance on the role of the audit committee, what a best practice committee looks like, and how it should work with both internal and external audit,” he says. “Working with the ECIIA will help us to give directors the practical insights they need to perform their role more effectively.” ■

“Due to the crisis, directorship might not have the professional appeal it had in the past. We have to fight and keep attracting people to the role”

Our mission

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- » To promote corporate governance and the profession in economically emerging countries, as appropriate, within the wider geographic area of Europe and the Mediterranean basin.
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