

European Governance

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Designs for the Future

Internal auditors gathered in Vienna this October to discuss how the European Union's corporate governance reforms could reshape their role and purpose

INSIDE: Nathalie Berger on strengthening the audit committee, report on future of corporate governance, ECIIA enhances visibility, internal and external auditing defined and much more



Transparency key to governance

The European Commission has put transparency at the centre of its drive to reform the region's corporate governance regime

The European Commission is using increased transparency in corporate reporting to strike the right balance between flexibility and hard rules in its reforms to the region's corporate governance regime, according to key organisations affected by the changes.

In a report compiled by the ECIIA, *The future of European governance: key views from key people*, Ugo Bassi Director in the European Commission's Internal Market DG in charge of the Capital and Companies Directorate, explains how the Commission has focused on the principle of greater transparency in reporting to bring about better corporate governance practice and to generate greater understanding among investors.

"We would like to inject as much transparency as we can into the system," he says in the document. He believes that this



strategy has enabled the Commission to move away from prescribing hard and fast rules that would

have been unpopular in much of the business community.

Bassi points to three recent areas of reform in which transparency has acted as a guiding principle: the current proposals on board diversity and the management of nonfinancial risks, the adoption of the "comply or explain" principle in reporting, and moves to improve shareholder engagement.

While the respondents have some reservations about certain details of the reforms, most supported the Commission's emphasis on transparency.

Participants included Patrick Zurstrassen, Chairman of the European Confederation of Directors' Associations, Carlos Montalvo, Executive Director of the European Insurance and Occupational Pensions Authority, Michel Denner, Vice President of Federation of European Risk Management Associations, and Armand Lumens, Head of Internal Audit at Shell.

"We wanted to ask those representing core participants in the corporate governance system whether they were happy with the direction the changes had taken," says Marie-Hélène Laimay, ECIIA Vice President. "The booklet represents a snap shot of views at the very time when organisations are getting ready for the new corporate governance landscape."

Download *The future of European governance: key views from key people*.



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ECIIA enhances visibility

The ECIIA has had its most effective year in promoting the value of internal audit in corporate governance in Europe, according to the ECIIA Activity Report 2013

The ECIIA has had its busiest year in promoting the value of internal audit, including launching new publications, enhancing its communications channels and liaising with key stakeholders.

It published three new guidance notes during 2012-2013, says the report. These were *Making the most of the internal audit function* (with Ecoda), *The role of internal audit under Solvency II*, and *Reinforcing audit committee oversight over global assurance and internal audit*.

It has worked hard to strengthen its relationships with partner organisations in Europe and to build new bridges. This has involved responding to public consultations, participating in a roundtable event at the European Parliament, and garnering the views of key players in the governance arena for publication in

its most recent brochure *The Future of European Governance: Key views from key people*, see page two.

“This year ECIIA has enhanced the visibility of the profession among European authorities and its targeted stakeholders,” says ECIIA Vice President Marie-Hélène Laimay, in her foreword to the report.

The ECIIA launched its new website at its annual conference in Vienna and plans to increase its press relations activities. The European Commission is to introduce a directive on the communication of non-financial information and on board diversity for large companies. And it is in the middle of a major consultation on audit reform in the region, so 2014 promises to be another busy year.

Download *ECIIA Activity Report 2013*.

Redefining the lines

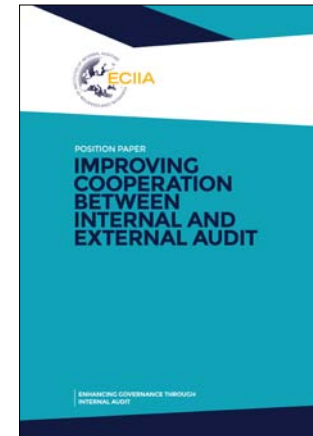
The boundaries between internal and external audit and the way they can best cooperate has been clarified in ECIIA guidance

The best way for internal audit and external audit to cooperate is the subject of the ECIIA’s most recent publication, *Improving cooperation between internal and external auditors*.

The report aims to both define the roles of the two audit functions and to outline the grounds on which each can best contribute to the success of organisations.

“Interaction and cooperation between the internal auditors and external auditors should help the governing body obtain a more comprehensive view of operations and risks whilst eliminating areas of possible duplication of audit effort,” says the report.

It says that good communication between internal and external audit should also benefit senior managers as both audit engagements and subsequent recommendations to the improvement of risk



management and internal control will be better coordinated.

It says that the risk information gathered by external auditors is typically limited to financial reporting risks, and does not include the way senior management and the board or audit committee are managing and monitoring the organisation’s strategic, business and compliance risks. But, the internal audit function can provide assurance

on these areas to senior management, as well as the governing body.

The subject was the topic of an event organised by *Parliament Magazine* and supported by ECIIA in November 2013. See page 8 for a profile for the views of Nathalie Berger, Head of Unit, Audit and Credit Rating Agencies, DG MARKT/F4 at the European Commission.

Download *Improving cooperation between internal and external auditors*.

ECIIA round up

ECIIA gains new president, IIA publishes life story and UK survey finds businesses unready for risk

Thijs Smit was elected President of ECIIA following the body's annual conference in Vienna at the beginning of October. He is expected to serve in the position for one year.

"This is an exciting time for internal audit," he said on taking up the presidency, "and I am very pleased to be able to bring my experience to ECIIA at a time when it is making its influence felt among decision-makers and participants in the European corporate governance arena."

Smit has been an internal auditor for 35 years, is a former President of IIA Netherlands and has been a member of the Board of Global IIA where he sat on its Ethics Committee and its Audit Committee. (Read his full biography here)

He succeeds Marie-Hélène Laimay who becomes Vice President. Melvyn Neate was also elected to the ECIIA Management



Board. He is past President of the Chartered Institute of Internal Auditors – UK and Ireland and is Non-Executive Director at the Office of Rail Regulation.

IIA Turkey has published a book charting the body's founding in 1995 by four people into a member organisation of both ECIIA and Global IIA and representing over 1600 internal auditors.

The book, *Global partner of*

excellence in the profession: the institute of internal auditing Turkey, was written by Gürdogan Yurtsever vice president of IIA Turkey, and edited by Ali Kamil Uzun, a founder of the institute and its honorary chairman.

The book described how the founders – Ali Kamil Uzun, Sinan Tanakol, Ersin Güneralp and Hüseyin Karaçalı – were united in their belief that the

crisis Turkey faced in the mid-nineties could be tackled by "risk-based pro-active auditing." They took out a subscription to IIA Global's magazine *Internal Auditor* and began to ask themselves why it would not be possible to establish an institute of internal auditing in Turkey.

Jean Pierre Garitte, then the Chairman of ECIIA, said he had been impressed by the Turkish delegation but, at the time, he doubted whether four private individuals could succeed without the backing of government or private enterprise. It is a testament to their passion and enthusiasm for internal auditing that they did. The challenge now, says the book, is to pass the baton on to the next generation of auditors in Turkey.

Forty-five percent of chief internal auditors surveyed by the Chartered Institute of Internal Auditors – UK and Ireland rated their company's awareness of

risks to the business and the effectiveness of its processes as "in the early stages," "in development," or "non-existent."

The study – *Governance and Risk Report 2013* – revealed that companies considered data privacy and security as one of the top risks. The CIIA said that a large number of businesses were without adequate arrangements in place to spot potential dangers or minimise any impact.

"The financial crisis has prompted a major reassessment of how risks are managed in the financial services sector and internal audit's role in supporting better practices. But many organisations, particularly outside of financial services, are recognising too slowly the need to understand the full scope and nature of the risks facing their organisations," Dr Ian Peters, IIA Chief Executive, said.

Download *Governance and Risk Report 2013*.

Designs for the future

Internal auditors gathered in Vienna this October to discuss how the European Union's corporate governance reforms could reshape their role and purpose

In the wake of the financial crisis, boards and company shareholders are beginning to focus on long-term value. The question, said Marie-Hélène Laimay in her presidential address to the ECIIA's annual conference in Vienna, is how can internal audit help them achieve that objective?

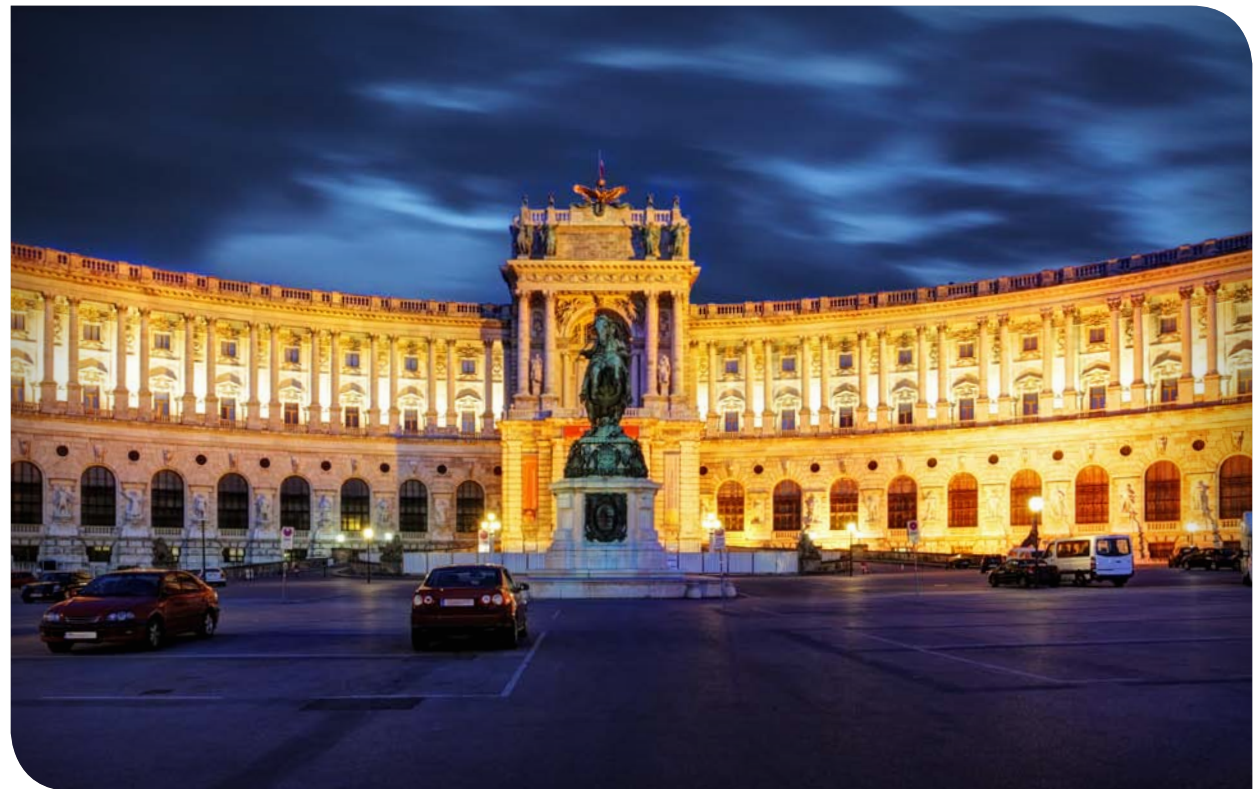
The event, organised in October by IIA Austria at Vienna's Hofberg Conference Centre, was attended by 550 internal auditors from Europe and around the globe.

Laimay said that Europe was in the process of designing the right governance model for the future and had already learned valuable lessons. That included the need for better, independent communication from shareholders on company performance and increased transparency in company reporting.

She underlined the ECIIA's commitment to the Three Lines of Defence Model of corporate governance, where internal audit provided the third, independent line of assurance on an organisation's risk management and controls.

"The Three Lines of Defence model provides a structured corporate governance system that establishes clear roles and responsibilities," she said. "We have been promoting its use to the Commission and our strategic partners."

Paul Sobel, Chairman of Global IIA, told the conference that while the financial crisis had helped raise the profile of internal audit, the profession now had to begin to define how it was going to meet the future for itself. "What can we become?" he asked. "And »



The Three Lines of Defence model



» how are we going to get there?”

He outlined a roadmap to tackle the immediate challenges and said that auditors should focus on what he called the “five I’s to the future”: innovation, insight, intuition and interface and inspiration.

Innovation could involve forms of creative disruption, he said, in order to transform the audit process to become more aligned with stakeholder needs. On the last point, he said, “We need to inspire each other to create a new future.”

Eyes and ears

Andreas Triechl, Chief Executive Officer of Erste Group Bank, said

that internal auditors working in the financial sector had seen a dramatic increase in responsibility in the fallout from the financial crisis. He said the eyes and ears, not just of managers, but of regulators and shareholders were now on the profession.

That was because some supervisory authorities increasingly use the work of internal audit in their own risk assessments of the businesses they regulate.

“Is this likely to change the relationship between management and business?” asked Triechl.

“Yes, it will be a huge change.”

But he said that there was »

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Left to right: Angela Witzany – President IIA Austria, Paul Sobel – Chairman Global IIA, Dr Erich Hechtner, Richard Chambers – Global IIA President and Chief Executive

» likely to be some “pain” for those adjusting to the additional pressures. Internal auditors would need to focus much more on damage prevention and become forward looking. “Transparency in the business world forces internal audit to play a more active role,” he said.

“The days when you can be more mediocre are over,” he said. “If a business in the financial services sector is not also best in internal audit in the future, it will fail. That puts you in one of the most exciting parts of the business you can be in.”

Klaus Gressenbauer, Director of Internal Audit at European Central Bank, speaking in a personal capacity, said that some internal auditors may have believed that their role was to be forward-looking prior to the financial crisis, but they were caught out with everyone else.

“Should we fall into self-accusation because we couldn’t read the tea leaves in the cup?” he asked. “No, but we should be prepared to learn the lessons.”

He said that most of the problems that caught people out in the run up to the crisis were relatively simple, but existed in a

complex environment. In his view, internal auditors would benefit from focusing on a few basic lessons.

“Put human capital at the top of the agenda,” he advised. He said that crisis management had reduced the time and budgets allocated to internal audit training. He said that functions should increase the amount of internal audit training and employee and management development, adding that 80 hours a year was warranted, but still not enough.

Second, he said, that chief audit executives should resist pressure from senior management to audit organisational units and concentrate instead on process auditing. “The majority of failures and control deficiencies occur at the borderlines within organisations,” he said.

He also argued that auditors should consider moving away from annual audit plans, that they should improve their communication with auditees, become the focal point for assurance within the business and learn from their previous mistakes.

Re-evaluation

Friedrich Bräuer, Head of Unit Internal Audit EU Agencies and

Bodies, at the Internal Audit Service European Commission, said that internal auditors had an opportunity to help management re-evaluate its view on risk.

“The primary focus has been on risks that, in management’s judgment, have high impact on the enterprise and are likely to explode tomorrow,” he said. “They don’t necessarily step back and manage

internal auditors to know their stakeholders and to understand their differing expectations. He said that one concrete measure of the stature of internal audit could be found in to whom the function reported. According to Global IIA’s research, approximately two-thirds of chief audit executives reported to either the chief executive officer or chief

“Should we fall into self-accusation because we couldn’t read the tea leaves in the cup? No, but we should be prepared to learn the lessons”

their vulnerability by asking what damages they need to manage.”

He said that internal auditors could add value by helping management focus the spotlight on risks that have high potential impact and where management believes the enterprise is most vulnerable.

Stakeholders

Richard Chambers, Global IIA’s President and Chief Executive Officer, said that it was vital for

financial officer administratively, and two-thirds reported to the audit committee or full board functionally. These statistics were trending upwards, he said.

But the board and executive management had different expectations, he said. On assurance, for example, the board tended to look to internal audit for full audit reports, while management may be happy to receive the chief audit executive’s opinion informally at times. »

“The one thing internal auditors most under-rate, is an ability to build and sustain relationships with management, the board and others.”

» According to a PwC report, while 79% of board management believe that internal auditors add significant value to their organisations, fewer than half (44%) of executive managers held that view. He said that internal auditors needed to communicate better the distinction between the second and third lines of defence to fully communicate the value that they added to the business. And to make sure they explain properly their audit findings and how they impact the business.

“The one thing internal auditors most under-rate,” he said, “is an ability to build and sustain relationships with management, the board and others.” This would be one of the critical things for raising the bar in 2014 and beyond, he said.

Phil Tarling, Vice President, Global Internal Audit at Huawei Technologies Ltd said that internal

auditors needed to adapt to an increasingly multi-cultural business environment and not assume that Western ways of working could be automatically grafted onto Eastern culture. “In a Chinese company,” he said, “everything is decided by consensus. You have to have patience to achieve that in an audit department with 180 people in it.”

While there are lots of challenges ahead, the plenary and sessional speakers offered plenty of advice and encouragement to delegates to seize the opportunities before them. Hannes Arch, the Red Bull racing world champion, a key note speaker at the conference, said people should not be afraid to face new dangers. Sharing his experience of jumping from the top of a mountain, he said: “When you know there’s no way back, you get calm and strong – and when you have done it, you want to do it again.” ■

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Strengthening the audit committee

The European Commission is aiming to improve the quality of audits for public interest companies. This entails giving the audit committee more independence and power, says Nathalie Berger



Nathalie Berger

While the European Commission's proposals to improve the quality of auditing in public interest companies has been the subject of debate since they were first published in 2011, discussion has more recently turned to how the work of internal and external audit can be better coordinated.

The reason is easy to see. External audit primarily provides the board with assurance over the organisation's financial performance. Internal audit, on

the other hand, gives assurance on a broader range of issues and the controls over its risks. Together, the two functions should enable the board to see clearly how the company is performing and the risks it faces, but without effective coordination between them there can be gaps in the picture and duplication of effort.

Speaking at a recent event organised by the ECIIA with the support of *Parliament Magazine*, Nathalie Berger Head of Unit, Audit and Credit Rating »

“We are aiming to give stronger monitoring powers to the audit committee over financial reporting, the effectiveness of internal controls and risk management”

Audit committee's central role

- Audit Committee plays a central role in the corporate governance models of EU Member States
- Audit committees, or bodies performing an equivalent function within the audited entity, have a decisive role in contributing to high-quality statutory audit
- Both internal auditors and external auditors share their findings with the audit committee
- A strong audit committee is a precondition for protection of the interests of shareholders and investors

Source: *Nathalie Berger, presentation*

» Agencies, DG MARKT/F4 at the European Commission, said that it was time to look at how cooperation between internal and external audit could be improved.

“If we look at the role of the audit committee, this is exactly where internal and external audit can and should meet,” she said. “That is why we think the audit committee should play a key role in improving this relationship.”

Re-examining roles

In fact, the Commission has been re-examining the role of the audit committee, not just in light of the recent financial crisis,

but also in terms of its failure to prevent corporate collapses such as Enron and WorldCom.

“In too many cases, the audit committee was lacking in independence,” she said. “Corporate governance practices did not sufficiently – or at all – empower audit committees.”

The audit committee plays a central role in the Commission's reforms to enhance the quality of audit (See *Audit committee's central role*). She says that because internal and external auditors both share their findings with the audit committee, it is ideally placed to ensure effective

coordination between the two functions. On a practical level, for example, it is well placed to facilitate good dialogue and communication between them during the statutory audit process.

“We are aiming to give stronger monitoring powers to the audit committee over financial reporting, the effectiveness of internal controls and risk management,” she said. “The audit committee will play an even more important intermediary role by analysing and sharing risk assessments and audit findings.”

She believes that strong, independent audit committees would help to enhance confidence among investors and shareholders that organisations are well managed.

In this area, the reforms are directed at strengthening both the position of audit committees and the powers at their disposal. To be effective, she says, audit committees need to be independent of executive management. They should be composed of non-executive directors who are mainly independent of management, and a chair who is totally

independent. And there should be synergies on the board between expertise in auditing, accounting and a knowledge of the specific business sector in which the company is active.

Auditor appointment

Given these conditions, she said, the audit committee would be in a strong position to select and appoint the external auditor.

“If we look at the role of the audit committee, this is exactly where internal and external audit can and should meet”

This would help minimise the threat to the independence of the external audit firm. During the Enron crisis, for example, the relationship between external audit and executive management was found to have been too close.

Under the Commission's proposals, an external auditor would have to confirm its independence before accepting the assignment. And the appointment of the auditor »



Left to right: Nathalie Berger – Head of Unit, Audit and Credit Rating Agencies, DG MARKT/F4 at the European Commission; Marie H  l  ne Laimay – ECIA Vice President; Sajjad Karim – MEP; and Isabelle Tracq-Sengeissen – CNCC Auditing Standard Board Vice President

» presented to a meeting of shareholders would be based on a justified recommendation of the audit committee, after a mandatory selection procedure.

The audit committee would have other powers to safeguard the firm’s independence (See, *Ensuring external auditor independence*).

“This label, or guarantee, of

independence will put the external auditor in a stronger position with executive management and with investors who will read the audit report,” she said.

Long-form

As well as producing an audit report for shareholders, the external auditor would be responsible for producing a second, “long-form” report for the eyes of the audit committee alone. This would enable the discussion of more market-sensitive

“This label, or guarantee, of independence will put the external auditor in a stronger position with executive management and with investors who will read the audit report”

Ensuring external auditor independence

- The statutory auditors should confirm annually to the audit committee their independence and discuss any threat to their independence as well as the safeguards applied to mitigate those threats.
- The audit committee would be empowered to bring a case before a national court on the dismissal of the auditor.
- Disclosure to the audit committee of percentage of fees received by the statutory auditor.
- The audit committee should consider whether the audit engagement should be subject to a quality control review by another statutory auditor or audit firm prior to the issuance of the audit report.

Source: *Nathalie Berger, presentation*

issues including, the scope of the audit, material uncertainties, instances of non-compliance and reasons for disagreements.

There would be good reason for external audit to rely on the work of internal audit in producing its reports, she said. International Standard on Auditing 610 provided guidance on how such work could be used during the statutory audit. But, she said, that relying on these findings did not discharge external audit from its responsibilities.

The debate over how best to

improve coordination between the two functions is likely to roll on for some time yet – not least because increasing the independence of the audit committee would have important implications for the role of internal audit itself.

Nathalie Berger was speaking at an event organised by the ECIA with the support of *Parliament Magazine*.

Download the ECIA’s position paper: *Improving cooperation between internal and external audit*.

Our mission

- » To be the consolidated voice for the profession of internal auditing in a widely defined Europe by promoting sound corporate governance with the European Union, its Parliament and Commission and any other European or global institutions of influence.
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