

# European Governance

THE OFFICIAL MAGAZINE OF THE ECIIA

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## Getting governance right

2012 ECIIA conference report

INSIDE: Covering codes, Internal audit in banking, Cyprus governance overhaul, Institutes' news, events and more



## Converging codes?

Nine out of ten EU member countries require or recommend some form of internal audit function in listed companies, according to research by the ECIIA released at its annual conference in September (See pages 4-7 for conference report).

But, says the document – *Corporate Governance Codes on Internal Audit* – there is little regulation ensuring that internal audit is effective, particularly in regards to its independence and scope.

The ECIIA's own benchmarking studies have revealed that as

a consequence of the financial crisis many corporations have slashed resources in internal audit, while expecting them to maintain their full mandate.

Carolyn Dittmeier, ECIIA president, speaking at the annual conference in Amsterdam, said that the paper would inform debates in the European Union about the need or desirability to converge national corporate governance codes as part of its current review of the topic.

"We have already found a certain amount of convergence," she said, "and the research suggests a more unified model

of corporate governance is needed. But the real question that the EU needs to address is how to make internal audit more effective within that framework."

The ECIIA has already discussed the need for the EU to adopt the so-called Three Lines of Defence model of corporate governance at a meeting at the European Parliament during the summer.

**For a copy of *Corporate Governance Codes on Internal Audit*, click here.**

**To read a report of the proceedings at the European Parliament, click here.**

### Events

IIA Sweden is holding its Annual Conference on 25-26 October 2012. The theme of the event is *Crisis, communication, culture*. It will take place at the Stockholm Waterfront Conference Centre in the heart of Stockholm. Global IIA's chairman for 2012-2013 Phil Tarling will give a

keynote speech called "Say it right." Other prominent speakers include Fiat's Mauro di Gennaro, who will deliver his paper "An Italian-multinational internal audit: the case of Fiat S.p.A, audit and compliance". **For programme, click here.**

The Czech National Conference, "How to address quality in internal audit" will

be held between 10 and 11 October 2012. The proceedings take place in the Czech Republic in Mikulov and will be conducted in Czech. **For more details, click here.**

IIA Portugal's XIX National Conference of Internal Auditing will be held in Lisbon, in 22nd November 2012. **Click here, for details.**



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## Internal audit in banking



Roger Marshall

The IIA UK and Ireland has announced the creation of an independent, industry-led committee to recommend fresh practice guidance for internal auditors working in the financial sector.

The committee is to be chaired by Roger Marshall, a director of the Financial Reporting Council and chair of its Accounting Council. Marshall is also

chair of the audit committee of the insurer Old Mutual.

“Analysis of the financial crisis and more recent problems in the banks emphasises the need for internal audit to be at the heart of corporate governance,” Marshall said. “To enable this, all parties with an interest in the governance of financial institutions need more specific guidance on the role of internal audit.”

Marshall said that the aim of the guidance would be to balance the interests of executives, boards and regulators in addressing the challenge of improving internal audit’s contribution to how risk is managed in banks and other financial institutions.

Ian Peters, chief executive of IIA UK and Ireland, said that the IIA’s own *Standards* would form the basis of the new guidance. “The new committee will take these standards as their starting point and create guidance on their interpretation which all internal audit’s stakeholders agree is appropriate for the sector,” he said.

**For more information, click here.**

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# Cyprus governance overhaul

## Round up of news from the national Institutes

Cyprus IIA was officially appointed by the Cyprus Stock Exchange (CSE) as one of the members of the consultative committee for the National Corporate Governance Code. The development was a result of a long-term advocacy initiative by IIA Cyprus.

President of IIA Cyprus, Onisiforos Onisiforou, attended a meeting of the consultative committee for the first time on 24 May 2012. Onisiforou put forward proposals for amending the Code to further improve transparency, governance, risk management and internal audit. The proposals of IIA Cyprus were accepted and the National Code will be revised and updated accordingly.

The fourth Expert Meeting, was hosted by IIA Bulgaria on 28-29 June 2012. The



Source: Aspect of Cyprus

conference, entitled “The new reality for internal audit”, brought together more than 150 internal auditors, professionals and experts. The forum was held in Sofia, celebrating the day of the internal audit in Bulgaria.

Meanwhile, Krasimir Logofetov has been elected as the IIA Bulgaria chairman of the board. He has wide experience in the areas of control, audit, analysis and consulting. He is currently chief audit executive of VIVACOM,

a leading telecommunication company in Bulgaria.

IIA Portugal held its VIIth Annual Forum on 21 June 2012 for internal auditors. The theme was “Internal control and sustainability of organizations”. The event attracted 170 participants from various sectors and companies. The author of the best academic paper about internal auditing in all universities and polytechnic schools teaching auditing in Portugal received an award. The

event took place during the year when IIA Portugal celebrated its twentieth anniversary.

ECIIA and IIA Azerbaijan’s joint conference, “Internal audit: realities and perspectives” took place in Baku between 3-4 May 2012. ECIIA board member Kristina Bernotaite delivered a keynote speech, “The three lines of defence model in internal audit”. Representatives of the Ministry of Finance, the Ministry of Economic Development, the Ministry of Taxes, BP, the State Oil Company of the Azerbaijan Republic and others participated in the conference.

IIA Sweden has established a Professional Practices Committee chaired by Olof Arwinge of Grant Thornton. The committee will influence and develop policy related to governance and internal audit.

**For more news on IIA Cyprus, [click here.](#)**

**For more news on IIA Portugal, [click here.](#)**

# Getting governance right



Carolyn Dittmeier

As the next wave of European governance is set to emerge, delegates at the ECIIA's annual conference asked whether enough attention had been paid to ethical behaviour, as Arthur Piper reports

**“The** stakeholder community is not only unhappy with the way that corporate governance has been working in Europe,” ECIIA president Carolyn Dittmeier told the ECIIA's annual conference in Amsterdam this September in her keynote speech. “They are a little bit angry too.” She said that the ECIIA had been advocating the confederation's views on corporate governance to the European Union at a time when the law-setters had consulted widely on changing the regime following the financial crisis.

She urged delegates to pay attention to issues ranging from company structures, shareholder responsibility and external

supervision, to strategic risk management and the board. While many internal auditors took notice of the rules that applied to their own

the EU has suggested that the board of an organisation become responsible for approving the risk model that the business uses.

**“As an internal auditor, you have a responsibility to listen to what people are saying to you because if you don't listen you're going to get it wrong”**

regions, few paid as much attention to EU-wide governance issues.

That had to change, she said, because the EU's forthcoming reforms would have a major impact the way internal audit operated across the region. For example,

Internal audit could play a key role in providing the board assurance on such issues, she said.

## Step change

The theme of Phil Tarling's year as Global IIA chairman was “Saying »

## “With so many functions in each business doing the checking and controlling, is there a specific area where internal audit can add most value?”

» it right,” he announced during his keynote speech. But “saying it right” in today’s world, which is highly connected by social media and the diverse audiences it enables, involved a step change in the way that auditors need to think, he said.

That entailed understanding different audiences and communicating to them clearly. “As an internal auditor, you have a responsibility to listen to what people are saying to you because if you don’t listen you’re going to get it wrong,” he said.

Recent surveys showed that major stakeholders were demanding that internal audit become more involved in helping the business achieve its objectives. Unless internal audit functions were prepared to listen and tailor their work accordingly, in-house teams could see themselves out of business, he warned.

To become more relevant,

Tarling said, internal auditors needed to focus on key business risks and come up with workable solutions. “People, including audit committees, want a straight forward message,” he said, “and that can often be summed up by the question, ‘what do I need to do?’”

### Moral judgements

Jaap Winter, a partner at the legal firm De Brauw Blackstone Westbroek in the Netherlands, provoked the audience to consider whether they relied too much on controls and systems at the expense of exercising their own moral judgements. He said that in times of crisis, people often tried to lay the blame at the door of others, rather than honestly appraising how their own behaviour may have contributed to the initial problem.

“When there are too many rules, people can often displace their responsibilities onto rules, rather »

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Phil Tarling

» than accepting that they have a responsibility to accept the affect of their own actions,” he said.

Echoing the theme of Tarling’s talk, Jaap argued that internal auditors “needed to build a shared language” of responsibility, where responsibility meant recognising one’s ability to respond to a given situation. At the root of this approach, he said, was the concept of integrity. If an internal auditor could keep their promises, or say immediately when that became impossible, that would help create such an approach in the organisation.

Richard Chambers, president and chief executive officer at Global IIA, said ethics had become more important because charges

against companies increasingly implicated internal auditors. “The thing that keeps me awake at night is the thought that someone who is an internal auditor is going to commit a serious ethical breach that will stain the reputation of the profession,” he said.

He gave some high-profile examples of where companies had been accused of bribery or corruption and the chief audit executive was thought to have been involved. While he said that he did not think that these cases represented “an epidemic of ethical lapses in the profession,” he did believe that it was time to reflect on the profession’s core principle of acting with integrity.

He said that the IIA’s own

internal auditors should see *The Code of Ethics* as a blue print for ethical behaviour. But Global IIA’s own research showed that about one in three internal auditors did not follow the *Standards*. “Not having an independent review of your internal audit function is an ethical failing,” he said.

The reality for internal audit, he said, was that “ethics was not about black and white, it was about shades of grey.” He said that it was important for internal auditors to work on their blind spots and understand that their interests are likely to affect their beliefs.

On the second day of the conference, Deanna Sullivan, founder and principal of Sullivan Solutions, picked up on the subject



T. Fleming Rudd

of blind spots in her presentation on how internal auditors could better present themselves within their organisations. She said that verbal blind spots could be particularly damaging, citing research that showed that six out of ten management failures could be traced to faulty communication.

One way of addressing that was for internal auditors to improve their personal communication skills, she suggested. She said that understanding other people’s personal communication style was a first step towards being able to communicate internal audit’s own image in a positive way.

“Learning more about how you are perceived verbally and non-verbally, and marketing yourself accordingly, can help change the perception of internal audit within the organisation as a whole,” she said.

### Limitations

With increasing organisational demands on internal auditors, Professor of business administration at the University of St. Gallen in Switzerland T. Fleming Rudd, asked whether it was time to accept that there were some limitations to

what role the profession should play within their organisation.

He said that the role of internal audit had developed over the past fifteen years to reflect changes to the corporate governance structures in Europe and in its national countries. Since the governance system was likely to continue to evolve, as Dittmeier had outlined, he suggested that internal auditors might benefit from “focusing on something where they have prestige and knowledge,” rather than providing assurance across all areas of the business.

“With so many functions in each business doing the checking and controlling, are internal auditors merely duplicating what has been done, or is there a specific area where internal audit can add most value?” he asked.

He said that internal auditors should consider ensuring that lines of responsibility for risk were clear, that the work they did was sufficiently material to the organisation and that some redundant or immaterial controls could be cut.

Jules Muis, former president and controller for the Worldbank, challenged the audience to »

» think about whether some of its assumptions about corporate governance were well founded. For example, he said that while regulators were busy making alterations to Europe's corporate governance system in light of the financial crisis, "no governance model had ever prevented a major financial crisis."

world the phrase "might makes right" often described the behaviour of the board. "There is no fix for that. We should simply accept the fact and do it with open eyes and ears," he said.

He also said that it was wrong to believe that an internal auditor who gave assurance was better than one who did not. "If

## "The purpose of the IIA's Code of Ethics is to provide an ethical culture in the profession of internal auditing"

He said that while COSO, for example, discussed the "tone at the top" within an organisation as setting the standards for how the business behaves, he said that less attention was focused on the actual behaviour of board members.

"Institutions are not democracies," he said, "and we need to recognise that." He said that internal auditors needed to understand that in the corporate

we give false comfort, that can do more damage than good."

The conference was hosted by the Dutch IIA and attracted more than 600 delegates to the Beurs van Berlage centre in old Amsterdam. As well as the keynote speakers, there were twenty concurrent sessions on everything from providing integrated assurance, to fighting fraud and working better with risk management. ■

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Kay Swinburne

# Fixing external audit

Europe's external auditors are facing radical reform. The quality of their work needs to improve, but any change must benefit companies, says Kay Swinburne, the MEP with a key role in shaping the governance agenda

**It's** been an uncertain year for Europe's external audit profession. Last November the European Commission published reform proposals that could have a radical impact on the way the audit market works. In the next few months the firms will learn whether their efforts to dilute the Commission's plans have had any effect.

The Commission has blamed the audit firms for not doing enough to detect or warn about risky accounting and governance practices in the run-up to the 2008 financial crisis. It accuses auditors of lacking professional independence and scepticism.

Its reform measures aimed at fixing this include mandatory

audit firm rotation every six years, a requirement for public interest organisations to retender audit contracts on a regular basis, a

committee (known as JURI) and its Economic and Monetary Affairs Committee (ECON). Parliamentary backing is not guaranteed.

**“It's not as easy as it seems on paper. Forcing companies to change auditor could make things worse rather than better”**

ban on firms selling certain extra services to their audit clients, and the possibility that the larger firms might have to split up.

For these reforms to take effect, the Commission needs the support of the European Parliament – in particular its legal affairs

Kay Swinburne, the MEP drafting an opinion on the merits of the proposals for ECON, is in no doubt that the audit market needs reform. “Do I think audit is working across all the 27 European member states? No,” she says. “There are very different levels of audit quality.” »

## Reform agenda

The European Commission published its proposed reforms for the statutory audit of public-interest entities, such as banks and listed companies, in November 2011. They are aimed at enhancing auditor independence and make the statutory audit market “more dynamic”. The key measures are:

**Mandatory rotation of audit firms:** Audit firms will be required to rotate after a maximum engagement period of 6 years (with some exceptions). A cooling off period of four years is applicable before the same client can engage the audit firm again. The period before which rotation is obligatory can be extended to 9 years if the entity being audited appoints more than one audit firm to carry out its audit.

**Mandatory tendering:** Public-interest entities will be obliged to have an open and transparent tender procedure when selecting a new auditor, with the audit committee closely involved in the selection procedure.

**Non-audit services:** Audit firms will be prohibited from providing non-audit services to their audit clients. In addition, large audit firms will be obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest.

**European supervision of the audit sector:** The European Markets and Securities Authority would coordinate the oversight of audit firms that operate across Europe.

**For more information:** [http://ec.europa.eu/internal\\_market/auditing/reform/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/reform/index_en.htm)

» Swinburne is looking closely at the role auditors at financial institutions did – or didn’t – play in the run up to the 2008 crisis. There should have been dialogue

between auditors and regulators, “But that didn’t seem to have happened. I would like to see that role strengthened,” she says. Better reporting to regulators on risks and

accounting trends is not only needed in the financial services sector, she says; other regulated sectors such as energy, pharmaceuticals and health care need it too.

### Reform doubts

But Swinburne has serious reservations about some of the Commission’s reform plans (see box). She is opposed to mandatory auditor rotation, arguing that it takes an audit firm at least two years to fully understand the business of a complex client. “It’s not as easy as it seems on paper,” she says. “Forcing companies to change auditor could make things worse rather than better.”

Compulsory tendering is acceptable in principle, but only if the company has the option to reappoint the incumbent auditor, she argues. Tendering would help the audit committee to ensure the audit firm delivers to the expected standard, she believes, and would remove the presumption from the market that a tender is an indication that there is a problem with the existing firm. “I’m at least convinced that there is merit in looking at mandatory tendering,” she says.

Forcing accounting firms to

separate their audit and non-audit services would be counter-productive, she believes. “Do we want pure audit firms? No, I don’t think that is the way to go. I think some of the smaller firms that are trying to get into the larger audit market need the breadth and

**“There have been structural issues within the statutory audit market for many years. This is not just a financial crisis issue”**

depth of experience in non-audit services in order to complete a statutory audit. To get the expertise, it seems a certain engagement in non-audit services is essential.”

But action is needed to prevent conflicts of interest, says Swinburne. She wants each audit committee to publish a list of the services that it has decided that its audit firm can and cannot provide. They should then be able to explain and justify the list to their national regulators.

### Setting a standard

Reform will require a mix of hard laws and softer guidance, says

Swinburne. Legal rules will ensure minimum standards are met and better guidance – adopted on a comply-or-explain basis – will allow for flexibility. The Commission has criticised the comply-or-explain approach in the past, but Swinburne is confident that it works.

“People suggest that I should be more cautious about how well it works in some cultures, and that some member states need more of the stick than a comply or explain regime would suggest,” she says. “But I would prefer to start with those changes that need to be hard-wired put in place – such as the need for an independent audit committee – and when it comes to points that need to be modified as the market changes, a comply or explain regime is easier to adapt to changing circumstances than hard and fast rules would be. That is really important.” »

» However, explanations for non-compliance need to be more carefully scrutinised, she says. “It needs to be twofold. In systemically important institutions and sectors, regulators need to take a very active role in understanding those explanations and questioning them further when necessary, rather than just taking them as a matter of record. The shareholders also need to get far more actively engaged.”

### Boardroom reluctance

The Commission’s proposals have not been warmly received in boardrooms. “A well run company with an independent audit committee will feel that they are already on top of these issues, so these plans are unnecessary,” she says. “However, it is true to say that it is not there for all businesses across the EU 27. We do need to get best practice across all member states and all company sectors.”

Swinburne also believes action is needed to increase competition in the audit market, so that the larger companies have greater choice. But she fears that the Commission’s attempt to achieve this by forcing audit firms to stop providing non-audit services could

prove counter-productive if – forced to choose – firms opt to leave the audit market and focus on more lucrative non-audit services.

## Timeline

The wheels of European legal reform tend to turn slowly. In February 2013 the European Commission, the Council of Ministers and two committees of the European Parliament will start to negotiate a set of proposals that they can all support.

An ambitious timetable would see an agreed set of reforms implemented by January 2015 at the very earliest, says Swinburne.

“This could be completed politically by the end of next year, but there is a lot of dragging of feet going on,” she says. “Many member states do not think this is a huge priority and lots of issues connected to the Eurozone crisis should be on the agenda ahead of this.”

“Some of the more radical proposals that the Commission has in mind to increase competition in the audit market would come at a very heavy price, and that price would be paid by companies,” she warns.

Indeed, Swinburne is concerned more widely that the Commission is proposing “post-crisis” reforms in several areas without fully considering the impact. “There have been structural issues

within the statutory audit market for many years. This is not just a financial crisis, or a financial services, issue,” she says. “I think

we need to look fundamentally at what needs to happen across all sectors. For me, this is not about the financial crisis, this is about good audit and good corporate governance at all listed companies.”

### Internal audit reform

Internal auditors may take some comfort from the fact that the European commissioner responsible for governance reform – Michel Barnier – has directed his criticism

at the external audit profession, and not thrown much blame in their direction. But there is a danger here of complacency. “The commissioner tends to use the phrase ‘the dog that didn’t bark’ a lot,” says Swinburne. “I’m not sure

**“A well run company with an independent audit committee will feel that they are already on top of these issues, so these plans are unnecessary”**

which pack of dogs he is talking about, whether it is just external audit that he has a problem with, or if it’s the audit function in general.

“My suspicion is that it is the audit function in general that he is referring to and that he feels oversight of executives has been lacking at all levels in companies. Whether that is the fault of shareholders, external auditors or internal auditors, collectively there is a perception that people were not asking enough questions ahead of the 2008 crisis. If that is the case, then I think everybody is culpable.” ■

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