

European Governance

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Intrusive, tough and fair?

Key parts of Europe's new regulatory regime for banks come into effect in November this year. Members of the ECIIA's banking committee share their concerns and hopes about the system

INSIDE: Driving for transparency, ECIIA launches banking group, ECIIA signed a new agreement with EUROSAI, internal audit needs to be independent under Solvency II, new ECIIA board members, affiliates advocacy news and much more



Better assurance at lower cost

The ECIIA deepened its cooperation with the European Organisation of Supreme Audit Institutions (EUROSAI) at a meeting in Riga, Latvia this October when both bodies agreed on a further raft of joint initiatives.

They included creating a team of key people across the two organisations to coordinate their shared efforts, exploring the establishment of professional courses on matters of common interest and collecting information on implementation of audit



standards as well as planning for a range of co-organised events and publications.

“We are aiming to help auditors in the two bodies provide better assurance at a lower cost to their organisations,” Melvyn Neate, an ECIIA board member involved in the collaboration, says. “There is a grey area where the two professions overlap and our work together can help better clarify and coordinate the auditors’ respective roles and responsibilities so there are fewer black holes and little duplication of effort.”

Neate says that while

supreme audit institutions are external auditors and tend to focus more on financial management in public bodies, they often rely on the work of internal auditors at the organisations they audit. By sharing knowledge and working practices, he says, they can improve the effectiveness of both corporate governance and their own audit work.

In June, ECIIA and EUROSAI, which groups 50 supreme audit institutions

under its aegis, renewed their cooperation agreement. The document set the grounds for how knowledge sharing and consultation on issues important to each body is facilitated.

One of the early fruits of this renewed collaboration is the jointly-issued position paper *Coordination and cooperation between supreme audit institutions and internal auditors in the public sector*, which was published in June.

Download here.

Internal audit must be independent under Solvency II

Internal audit must be unambiguously independent if it is to play an effective role under Europe’s new regulatory regime for insurers known as Solvency II, according to ECIIA.

Guidelines issued on the implementation of Solvency II by the European Insurance and Occupational Pensions Authority

(EIOPA) demand explicit segregation of responsibility between the different governance functions, which ECIIA welcomes. But the consultation document in which these responsibilities are set out needs to be more specific about how the independence of internal audit is to be achieved.

“One of the tasks of

internal audit is to audit the system of governance,” the ECIIA says in its response EIOPA’s consultation paper on the subject. “This includes auditing other key functions such as risk management, compliance and the actuarial function and, therefore, internal audit has to be kept separate

from these functions.”

It says that key to internal audit’s independence are its relationship with the audit committee – which must be direct and confidential, where necessary – and the right to audit any part of the insurance business without limitation or influence from management.

Internal audit should also report functionally to the board and operationally to the organisation’s chief executive officer, it says.

Although non-binding, EIOPA’s guidelines are intended to ensure common, uniform and consistent application of the new regime by national supervisors and affected insurance institutions.

Growing role for internal audit in M&As

Internal auditors in the financial services sector are being brought in earlier to assess whether risks are being properly evaluated in major strategic events such as product launches, major investments and mergers and acquisitions, according to a report published in September by the Chartered IIA – UK and Ireland.

Internal auditors are seeing their sphere of influence and the value they deliver within their organisations transformed, as regulators focus ever more intensely on the management of risk, of which internal audit forms a vital part.

Building effective internal audit: putting the pieces together, is based on a series of interviews with heads of internal audit in a variety of financial services firms and incorporates comments from the regulators. The interviews were designed to

identify good practice following the introduction of the IIA's Financial Services Code last year.

"The feedback we have received is that the role of internal audit is now seen by the regulators as a key indicator of the good governance of risk," said Dr Ian Peters, chief executive of the Chartered IIA – UK and Ireland. "Leading firms appear to be stepping up accordingly, particularly since the introduction of our new Code last year. Heads of internal audit have been able to use this as a valuable driver for change. These examples of good practice should serve as a wake-up call for firms both in financial services and beyond."

Download: *Building effective internal audit: putting the pieces together.*

Download: *Financial Services Code.*

Working hard to promote value

The ECIIA has worked hard over the last twelve months to promote the value of internal audit in European corporate governance, as detailed in its *Activity report 2014*.

One of ECIIA's key messages has been that good coordination

between internal and external audit adds real value and increases the effectiveness of corporate governance. The report lists a wide range of initiatives started or completed in 2014.

"Twenty-fourteen was a busy year for us, but 2015 promises

to be even more important," Thijs Smit, ECIIA President says. "We will continue to represent the profession, ensuring that the role of internal audit and best practice are properly understood and taken into consideration."

For the full report, [click here.](#)

Witzany new ECIIA Vice President

Angela Witzany, President of IIA Austria, was elected ECIIA Vice President at the body's General Assembly, which took place in Budapest in September 2014.

Witzany, a member of ECIIA's management board, has been working to strengthen and promote the internal auditing profession for a number of years. This has included working as Vice President of the Committee of Internal Audit and Control within the Insurance Association in

Austria and leading the permanent working group of Private Insurance Companies for IIA Austria. She is also a member of the Global IIA's Professional Certification Committee. Since 2001, she has been head of internal audit for the Austrian Insurance Company Sparkassen Versicherung AG, Vienna Insurance Group.

In addition, the management board welcomed Farid Aractingi as a new member. He is the chief audit, risk and organisation

officer at Renault. He is also the Chairman of the Board of the IFACI, the French Institute of Internal Auditors. Aractingi joined the board of directors of IFACI in 2010 and chaired its audit committee, before being elected Chairman of the Board in April 2012.

Thijs Smit retained his role as ECIIA President. Marie-Hélène Laimay, who was ECIIA President between 2012-2013, stepped down from the management board at the meeting.

Affiliate news

IIA Hungary organised and hosted the 2014 ECIIA event and CEE conference – *Experience the flavours of audit* – in Budapest on 18-19 September 2014. There were over 300 participants and 30 speakers from 20 countries.

Robert Kollar, President of IIA Hungary, opened proceedings, followed by a distinguished line-up of speakers. Anton van Wyk, the Global Chairman of IIA from South Africa described how the rapidly changing business environment and was creating a new breed of “hybrid” leaders, to whom communicating audit’s message can be a challenge. ECIIA President Thijs Smith talked about the challenges of internal audit following the recent reforms to corporate governance within the European Union. Other speakers included EY partner Ferenc Biro, Professor Ilya Avianti of the Indonesian Financial Services Authority, Ramses Gallego, ISACA vice-President, Rudi Hex, ex-President of IIA Belgium, Tomas Pivonka of IIA Czech Republic, Stanko Tokic from IIA Croatia, Hans Nieuwlands from IIA Netherlands



and a host of others. Attendees enjoyed a range of festivities and networking opportunities in the capital Budapest.

IIA Norway is lobbying the Norwegian Ministry of Finance to mandate internal audit in the public sector and produce a better governance model for the future. While the OECD published its report *Value for money in government* in 2013, recommending better standards for internal auditing as a priority reform, IIA Norway says that the government has so

far only taken “baby steps” to implementing effective measures. The government has mandated the use of IIA Standards, but does not require compulsory internal audit in central government departments.

IIA Norway and the Norwegian Institute of Directors (Styreinstituttet) jointly published a 4-page summary in Norwegian of *Making the most of the internal audit function*, originally published by ECIIA and the European Confederation of Directors’ Associations. Chief executive of IIA Norwat Ellen Brataas says, “This is a major step in demonstrating that we are working off the same page as our most important stakeholders. We believe that internal auditors are a significant tool in supporting the board of directors in their oversight of the enterprise’s governance system. However to make the most of a tool you need a set of instructions, which is what the summary aims to provide at a very basic level.”

Download: Hvordan få mest utbytte av intermrevisjon?

IIA Cyprus and the Cyprus

Business Ethics Institute co-hosted an event *Business ethics and internal audit* on 28 May 2014, at the University of Nicosia. The event was part of IIA Cyprus’s advocacy programme during the *International internal audit awareness month*. President of IIA Cyprus Mrs Soteroula Savvidou and former President Onisiforos Onisiforou, both addressed the meeting on internal audit and ethics. It held its Annual General Meeting on 4 June in Nicosia and a wide range of stakeholders attended, including government officials, academics, business leaders and IIA members.

IIA Latvia has signed a cooperation memorandum between non-governmental organisations and the Cabinet of Ministers. The document is designed to strengthen and encourage effective, open and honest public administration. As a result, IIA Latvia has been invited to nominate a representative for the evaluation committee that will select the non-governmental organisations that will work on the Society Integration Foundation Board.

Intrusive, tough and fair?



Key parts of Europe's new regulatory regime for banks come into effect in November this year. Members of the ECIIA's banking committee Henrik Stein and Thierry Thouvenot share their concerns and hopes about the system with Arthur Piper

In November 2014, the European Central Bank (ECB) assumes new banking supervisory responsibilities as part of wide-ranging changes to the way financial services businesses are regulated across Europe. The new regulatory framework, known as the Single Supervisory Mechanism (SSM), sees the ECB doing the leg work with national regulators and authorities to oversee large banks – significant credit institutions.

This is a key part of the

European Union's response to the banking crisis of 2007-2008, which started with the sub-prime mortgage selling scandal in the US and ended with Europe suffering one of its worst ever recessions. A primary aim of SSM is to help banks manage risk better.

Danièle Nouy, chair of the SSM's supervisory board, told *The Times* of Malta in October: "Supervision will be intrusive, tough and fair." She said the SSM would provide a thorough, »



» comprehensive and tough supervisory framework to better detect risks developing within financial institutions. If the supervisors detect a problem, they have the power to step in and impose sanctions. Would it stop another financial crisis? That would be an absurd aim, she said. “However, we strongly believe that there has never in the past been a European institution better equipped to minimise such a risk,” she concluded.

The ECB will be auditing large banks against standards set by the European Banking Authority

(EBA) based – of all places – in London, where banks are exempt from its scrutiny. EBA is setting the standards, frameworks and rules that form the technical guidance to the system.

Focus on governance

Henrik Stein, chairman of the recently formed ECIIA banking committee, says that while European regulation has so far focused on capital and the risk bearing capacities in banks, the SSM is moving attention to improving risk management through better

corporate governance. Draft guidelines from the EBA are looking at whether compliance and internal audit functions can become a more integral part of the governance system.

Stein welcomes the opportunity to promote the role of internal audit and the three lines of defence model of corporate governance within SSM. He says that it is crucial that regulators understand the three lines model, so that they are clearly aware of internal audit’s role as the final check on risk management systems and processes, after the more hands-on work of the units of the first and second levels of defence. “Once that understanding is in place,” he says, “it is easy for the standard setters to break down each issue and assign proper roles for the different functions and especially internal audit within the governance system.”

He expresses concern that SSM may be tempted to apply the same rules to every large bank in Europe in a way that could erase the historical differences and practices that give the region its strength –

after all, not all European banks had defective risk management practices before the crisis.

“Sometimes, more regulation places formalisation and bureaucracy over pragmatism,” he says. “Regulators and politicians often subscribe to the idea that ‘one size fits all,’ but I find it extremely difficult to apply

“It is crucial that the European regulator understands the three lines of defence model, so that it does not confuse internal audit’s role with the more hands-on work of the units of the first and second levels of defence”

such an approach to the hugely varied banking sector in Europe.”

Under the new system, regulators aim to collect more data from banks and use this to decide – through techniques such as stress testing – which institutions are deemed to be managing well, and which are not. Stein says this moves away from a belief in individual »

» risk modelling within banks towards an approach that shifts risk assessment over to the regulators. He worries that this threatens to take some autonomy for managing risks away from banks and could create a system where the banks that score less well could be put under special measures as a matter of course.

Responsibilities

SSM creates additional responsibilities for internal audit already, with more change in the pipeline. Stein says that the job of internal audit will become more dynamic, making the traditional multi-annual audit planning system less important. “The speed of changes is so enormous that internal audit has to find a way to reflect this in more responsive audit planning,” he says.

Not only that, he says the regulator is likely to request internal audit reports for review, perhaps on a quarterly basis, to see how many major findings they have reported and which areas have been audited. This situation could not only raise new challenges in report writing

– because a manager and a regulator inevitably read such information differently – but threatens to alienate internal audit from management. “Managers could become more sceptical of internal audit, seeing them as the proxy arm of the regulator,” he says.

Internal audit functions have to clearly communicate these pressures to their organisations and ensure that they do not see themselves as part of the regulatory system within the bank. He urges auditors to get up to speed with the new »



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Thierry Thouvenot

management within banks has elevated the value of internal audit within financial institutions.

“One of the NEDs’ major focus is their responsibilities and those are now closely related to the proper risk management of the organisation,” he says. If risk is not properly mitigated, NEDs could be accountable to a wide range of stakeholders, which has increased their remit to establish proper risk management systems within their banks.

“Executive committees and boards are working together to set the tone on risk management at the top,” he says. “When you have two key stakeholders at the highest level promoting the same message, it clearly strengthens risk management culture.”

Thouvenot says internal audit is well placed within the organisation to help NEDs. As the third line of defence, it provides a unique, independent overview of the effectiveness of risk management processes across the full scope of the organisation – a perspective not enjoyed by any other function. And it can provide relevant

feedback, information and advice to NEDs and boards, helping them to fulfil their duties.

Directive (CRD IV), for example, introduced the need for internal audit to review the salary and

“When you have two key stakeholders at the highest level promoting the same message, it clearly strengthens risk management culture”

But this more strategic role comes with additional pressures. Because the work is more complex, the function needs extra specialists within the team to deal with the tasks at hand. Traditionally, many internal auditors have had relatively general skills, often only staying within the profession for a few years before moving on. Thouvenot says this needs to change if internal audit is to cope.

There is no doubt, though, that internal auditors are increasingly trusted with sensitive and crucially important work. The Capital Requirements

remuneration packages within their banks – an area that had previously been widely off limits. But by checking that people within the organisation are being rewarded in a way that fits the bank’s risk appetite, the auditors are ensuring that the business is not encouraging excessive risk taking of the sort that contributed to the financial crisis.

It is this sort of valuable work that Thouvenot believes will win the support of boards, others in the bank and regulators. And such support is likely to be essential if internal audit is to realise its potential to help mitigate risk under SSM. ■

» regulations and make sure that they have the right skills to cope with some of the more complex techniques needed to review, for example, stress tests and other data-heavy topics.

Non-executive directors

Other recent reforms have also impacted internal audit. Thierry Thouvenot, the vice chairman of ECIA’s banking committee, says that additional requirements for non-executive directors (NEDs) – known as “fit and proper” – and more emphasis on risk

Driving for transparency

New legislation aims to bring more transparency to corporate behaviour. Guidance by ECIIA and FERMA should help those on the journey get a better understanding of how to achieve its objectives

European

organisations are facing sweeping changes to their governance models following amendments to article 41 of the 8th Company Law Directive and other reforms aimed at improving the

of financial services firms face the additional requirement of setting up a risk committee to work alongside their existing governance functions.

These changes will pose challenges to audit committees, internal auditors and risk

“Overall, the burden for audit committees is increasing and the knowledge requirements of their members is expanding”

effectiveness and transparency of corporate behaviour. Not only do audit committees have further responsibilities under the rules, but an increasing number

managers, not least because they will need to define and clarify their responsibilities in light of these recent developments. They will need to work together »



» to succeed in getting the most benefit from the rules.

That is why the Federation of European Risk Management Associations (FERMA) and ECIIA have published joint guidance on the 8th Company Law Directive, which was launched in October at a specially convened seminar. The document – *Audit and risk committees: news from EU legislation and best practices* – examines in detail how audit and risk committees should support their boards and be supported by their respective professions: risk managers and internal auditors.

The guidance identifies 10 possible responsibilities to share between audit and risk committees and is meant to help boards of companies and the chairmen of audit and risk committees to handle the increased EU requirements on financial and non-financial transparency.

“Overall, the burden for audit committees is increasing and the knowledge requirements of their members is expanding,” FERMA President Julia Graham says. She adds that in some EU countries reporting requirements



already go beyond what the regulators are now imposing, so that there were clear constraints on the time and resources that audit and risk committees faced when setting their agendas.

“The support of risk managers and internal auditors has become more relevant than ever to ensure meaningful and qualitative reporting,” she says.

“In this changing environment where regulatory and business burdens are increasing, it is important for each organisation to set up an efficient and integrated corporate governance model,”

Thijs Smit, ECIIA President, says. “This guidance clarifies the role of each actor in the governance arena and should help all the members of risk committees and audit committees.”

Two committees

The biggest change to the governance structure of financial firms, and those who choose to follow their lead, will be the creation of a specific committee dedicated to risk. There could be a number of reasons an organisation might set up a risk committee (See *Establishing risk committee*), but its members will need to be knowledgeable about risk governance, the business in which they work and have the authority to challenge the board or management on the decisions they make, says the report.

European banks must establish separate audit and risk committees under the Capital Requirement Directive (CRD IV). In non-financial organisations, the risk committee may be organised at executive level, either reporting to the audit committee, or chaired by the chief financial officer.

“The challenge for the

risk committee chair, as for audit committee chair, is to be constructively critical and use common sense advising the board,” Hans Erik Andersson says, a board member at the Norwegian insurer Gjensidige, who contributed to the report. “The board needs to trust the

“Cooperation between the audit committee and the risk committee is crucial to ensure a common risk management approach”

committees and also to challenge and ask the right questions.”

Those organisations that adopt this new structure need to ensure that the committees report to the board in a clear and effective way. That means where there is more than one committee, their roles and responsibilities need to be well defined so that the right information is passed to those who need it without undue duplication. “Cooperation between the audit committee and the risk »

Establishing a risk committee

The need to create a separate risk committee may arise for the following reasons:

- The requirements of the relevant regulator(s)
- The alignment between risk management and strategy
- The need for more detailed oversight of the risk management infrastructure (people, process, infrastructure)
- The complexity of the major/critical risks to be assessed

The chief risk officer or the director or head of risk management should participate in the meetings of the risk committee. The members of a risk committee should be independent and include independent board members (for example non-executive board members), as is also the case for an audit committee.

Source: *Audit and risk committees: news from EU legislation and best practices*

» committee is crucial to ensure a common risk management approach,” the report says.

“It’s vital that the three lines of defence model is effectively implemented and risk management as well as internal audit activity efficiently coordinated,” Smit says. Briefly, this model sees front-line managers holding responsibility

for risk, the second line comprising such advisors as lawyers and risk managers to help the front line in this respect, with internal audit providing the final check to ensure risk controls are adequate and effective.

Non-financial reporting

In April 2014, the European Parliament amended Directive

2013/34 – the Accounting Directive – to add disclosure rules for around 6,000 large companies across the EU. These regulations cover additional reporting requirements on the environment, social and employee matters,

within the next two years.

One of the central concepts introduced by the rules is materiality. The International Integrated Reporting Council has defined that as those issues that have a direct or indirect

“It’s vital that the three lines of defence model is effectively implemented and risk management as well as internal audit activity efficiently coordinated”

respect for human rights, anti-corruption, bribery and diversity, business models, procedures and risks related to these matters. As the co-legislator, the Council of the EU followed the European Parliament and adopted on the same terms the Directive on Non-Financial Reporting on 29 September 2014.

To smooth the implementation of these measures, European legislators say the European Commission must prepare guidelines on a methodology for reporting non-financial information

impact on an organisation’s ability to create, conserve or erode its economic, environmental or social value either for itself, its stakeholders, the environment or society at large.

This definition puts sustainability at the centre of the business’s long-term goals. Audit and risk committees as well as internal auditors and risk managers will need to make sure that companies can fulfil their obligations under the rules by having the right processes and procedures in place.

“Although in the majority of

cases organisations will already have established non-financial reporting processes, this does not mean they are ready to demonstrate management of the issues identified as material,” the report says. “Some might just keep reporting as before without ever making the jump to actual sustainability management.”

Organisations are going to have to work hard to get the benefits from the forthcoming changes. Involving risk managers and internal auditors in the process will be an important step along the way.

Download: *Audit and risk committees: news from EU legislation and best practices*

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- » 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.
- » 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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Director of the publication

Pascale Vandenbussche

Editor

Arthur Piper
arthur@sdw.co.uk
Direct 0115 958 2024

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Smith de Wint
95 Harlaxton Drive
Lenton, Nottingham
NG7 1JD
www.sdw.co.uk

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European Confederation of
Institutes of Internal Auditing
Koningsstraat 109-111 Bus 5
BE – 1000 Brussels, Belgium.

www.eciia.eu