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Audit revolution

The new banking supervision regime in Europe is pushing a revolution in internal audit practice



INSIDE: A view beyond numbers – the EU's initiative on non-financial reporting and internal audit's role; the future of the financial services sector; strengthening cooperation between auditors; affiliate news and much more



Bank remuneration monitoring must be clear

The European Banking Authority's (EBA) proposals on how the remuneration policies of banks are to be monitored need greater clarity if they are to be effective, says ECIIA.

The EBA's consultation document on the issue (EBA/CP/2015/03) is often unclear over which department is best placed to provide overall assurance to the board that its policies and procedures are sound. In particular, it confuses the independent, oversight remit of internal audit with the compliance roles of risk management and control functions.

"The task of the internal audit function is not to control but to work alongside others to audit the control functions, giving assurance to the board and the supervisory bodies that the policies are both well monitored and sound," Thijs Smit, ECIIA President says.

Control functions monitor whether the bank's remuneration



ECIIA President Thijs Smit

policies are in place and followed. Internal audit informs the board whether such monitoring is occurring and effective, and whether policies benchmark against industry best practice.

"It is essential for the EBA's document to reflect the fact that internal audit is the only function for the board, which is independent of management, that can oversee all of the other functions – including how well

risk management and compliance are working," Smit says.

He says that the most effective way for banks to be sure remuneration policies are working properly is for them to adopt the so-called Three Lines of Defence model of corporate governance. That provides internal audit with the independent remit it requires to perform this critical role.

Download the ECIIA response here.

No right way for internal audit

There is no right or wrong way to deliver internal audit. That is the conclusion of a new study by the IIA-UK and Ireland – *Models of effective internal audit*.

Organisations need to be free to choose what works for them according to the nature of what they do, how the organisation is structured, the way processes operate, their financial circumstances and the risks to their strategic objectives, the paper concludes.

Comprising a series of case studies, organisations explain what they care about and how they value internal audit.

One insight from successful functions is that they spend valuable time considering how to develop and improve their internal audit models.

"This is not just about keeping costs down, although

that is important," says the report. "It is about maximising the efficiency and effectiveness of professional practice – choosing a model that offers objective opinions, assurance and a range of experience and skills that positively impacts on the way the organisation delivers success."

The study also reveals how the profile of internal audit is being raised, creating higher expectations, new pressures and competition.

The case studies showcase six main delivery models: centralised in-house teams, distributed in-house teams, shared services, consortium arrangements, co-sourcing agreements with external providers, and outsourcing.

Read here: *Models of effective internal audit: how to organise a successful internal audit function*

Strengthening cooperation among auditors

Co-operation between internal auditors and supreme audit institutions is most frequently described as “informal” in European countries, according to a paper by Wim François of the Belgian supreme audit institution (SAI).

“Only a small number of SAI’s disclose, or report externally, on how their coordination and cooperation with internal auditors is arranged,” Francois says in the report – published in the magazine of the European Organisation of Supreme Audit Institutions (EUROSAI). “It is more difficult to assess an informal arrangement and it might also be difficult to ensure the quality of its implementation.”

An on-going collaboration between EUROSAI and ECIIA aims to improve how the two professions work together, as reported in the Autumn 2014 issue of *European Governance*.

François says that main methods of cooperation include communicating audit reports, regular meetings, and the use of each other’s work to determine the nature, timing, and extent of audit procedures. Supreme audit institutions are external auditors that tend to focus on financial

management in public bodies. They often rely on internal auditor findings in their work.

The benefits of closer cooperation between the two groups include:

- Exchange of ideas and knowledge
- A strengthened, mutual ability to promote good governance and accountability practices, and to enhance internal control
- More effective and efficient audits based on a clearer understanding of the respective audit roles and requirements

Members of the two professional bodies regularly meet and have formed an editorial committee. It will create communication networks to aid better collaboration.

“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 initiative, says.

Read the feature here.

A jointly-issued position paper, *Coordination and cooperation between supreme audit institutions and internal auditors in the public sector*, was published in June.

Download here.



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Affiliate news

The Central and Eastern European Internal Audit Conference – *Energy from a source of tradition* – takes place at Top Hotel, Prague in the Czech Republic on 4th – 5th November 2015. The event is part of the 20th anniversary of the Czech IIA.

Speakers include Anton Van Wyk, Global IIA's Chairman of the Board; Angela Witzany, President of IIA Austria; Jean-Pierre Garitte, ECIIA Past Chairman of the Board; Ranieri de Marchis, Head of Global Internal Audit at UniCredit Group; Johann Rieser, Senior Public Internal Auditor at the Ministry of Finance, Austria; Martin Novak, Chief Financial Officer at CEZ; Pavel Vosoba, Co-owner at MC Triton; Oldrich Kovar, Head of Internal Audit at Kronospan Group and Related Entities; and the Olympic decathlon Champion Roman Sebrle.

The program will be simultaneously translated in Czech and English. The conference is worth 12 CPE hours.

Register here.

Improved behaviour

IIA Slovenia has participated in a range of initiatives to improve corporate behaviour in the country. Last year, it took part in a government-backed project to fight corruption and strengthen corporate governance.

In October 2014, almost 30 national Slovenian corporations signed up to *The Slovenian Corporate Integrity Guidelines*, published as part of the initiative. Since then, over 30

more businesses have agreed to follow the guidelines.

IIA Slovenia also helped designate a new executive education program at the country's Centre of Business Excellence at the Faculty of Economics, University of Ljubljana. The program launched in March 2015.

"We strongly believe that all those activities will contribute to raising ethical behaviour in Slovenia," the affiliate said.



The Slovenian Corporate Integrity Guidelines

Role of audit committees

IIA Cyprus organised an educational event on the 20th of March 2015 in Nicosia, on the topic of *The role of the Audit Committee in Corporate Governance*. Fifty-four participants, mainly audit committee chairpersons and chief audit executives, attended the event.

Ms Soteroulla Savvidou, President of IIA Cyprus, stressed the importance of the role of the audit committee as a pillar of effective Corporate Governance and the role of internal audit as the third line of defence. Key note speaker Constantinos Triantafyllides, analysed and explained the new Governance Directive issued by the Central Bank of Cyprus in 2014.

Responsible business

IIA Croatia's Seventh Annual Internal Audit Conference took place on 16th-18th April 2015. The event – *Responsible business and the role of internal audit* –

attracted over 180 participants, and featured more than 40 speakers from nine countries.

Jasna Turkovic, President of IIA Croatia, opened the conference by pointing out the importance of the concept and practice of responsible business in both the private or public sectors.

"Responsible business represents widely adopted business practices in developed countries," she said. "The existence such practices are seen as evidence that an organisation is well managed, thus becoming a factor in making business decisions. Internal audit can be a key player in providing assurance to stakeholders that the efforts made in this direction produce results."

Speakers included Norbert Wagner, CEO IIA Austria; Zuzana Kitto of IIA Czech Republic; Laszlo Kovesi of IIA Hungary; Mirjana Bogicevic, ex-president of IIA Serbia; representatives from State Audit, Croatian Chamber of Auditors and Croatian National Bank and many others.



Audit revolution

The new banking supervision regime in Europe is pushing a revolution in internal audit practice, as Ernesto Martínez, President of IIA Spain explains

When the European Central Bank took over the supervision of the financial sector in Europe in November 2014, internal auditors in the industry knew they were facing change. That is because Single Supervisory Mechanism (SSM) – the name of the governance structure that enabled the ECB to preside over the sector – has given board members greater responsibility over their organisations' risk management processes.

For example, institutions must have board-delegated committees, such as an audit committee, that can reinforce risk management and supervision, and support the board as a whole. This means there is now greater demand for information

and reporting to the board and its committees. The trend is for effective and transparent communication channels to exist between the audit committee and all stakeholders.

A study carried out by PwC on the state of the profession of internal audit in 2014, reported that stakeholders were satisfied overall with the contribution of internal audit in traditional areas: financial controls, fraud and ethics. But they were less satisfied with the contribution internal audit makes towards other corporate initiatives, such as reviewing large projects, product launches, the management of investment projects and mergers and acquisitions.

Internal audit, therefore, needs to broaden its focus, a move that will

impact heavily on its future role and remit in the financial sector. Internal audit should abandon its traditional role of looking exclusively at control testing in mature processes, and should adopt a risk-based model that allows it to look at emerging processes and risks, which can add value to the organisation – those areas where the PwC study showed stakeholder dissatisfaction.

Stakeholder needs

A first step is for internal audit to really understand the expectations of each interest group. These needs may differ and change over time, but if internal audit is to communicate the services it can provide each one, it is essential to know what »

» such groups want. It is not an easy task. In 2014, the Spanish IIA carried out a major research project into the industry, including a survey of 50 chief audit executives in the country. The majority of respondents stated that one of the challenges for internal audit was to find the right communication channels through which it could extol its value-adding capacity to the organisation. In particular, respondents wanted to better understand stakeholder needs and become more proactive in meeting their expectations, but struggled to find the right mechanisms for making this a reality.

Internal audit also needs to win the confidence of its stakeholders. To do so, it should provide information that demonstrates that its activities are aligned with the business' critical risks, that its resources are efficiently deployed and that any deficiencies are adequately remediated.

Benchmarking studies are helpful in comparing the audit function to those of industry peers and through the use of metrics and KPIs, it will be possible to monitor the performance and development of the function. The number of requests from

management for internal audit to undertake special projects is a great barometer of stakeholders' confidence in the function and the value it creates. While IIA Spain's study found that these requests had increased, the growth was not significant, suggesting internal audit could do better.

New models

In the regulatory shake-up following the financial crisis of 2007-2008, there have been sweeping changes to banks' business models, regulatory requirements, the single supervisor, and the makeup of other stakeholders. This has had a knock on effect on the risk profiles of these organisations, leading to a shift in internal audit's resources and approach.

Internal audit should conduct its business while taking into account the organisation's risk profile, developing capabilities that keep it up to date in a changing environment, and employing innovative and creative solutions that add value. This change should be met head on by internal audit, which should develop the capacity to deliver real time responses to satisfy the expectations of stakeholders.

This transformation in internal audit can be seen in the new resources it will need to deploy to deal with and respond to the SSM and the evolved role audit committees now play. For example, internal audit staff and the chief audit executive undertake most of internal audit's administrative

“This change should be met head on by internal audit, which should develop the capacity to deliver real time responses to satisfy the expectations of stakeholders”

tasks, such as report writing for the audit committee and executive management. In the short and medium terms, an effective SSM will require more and more information from the entities. This additional requirement will mean that resource planning will have to take into account any extra hours dedicated exclusively to covering this task. This is likely to drive organisational change, with separate audit teams doing fieldwork and reporting.

Some larger entities already have specific teams dedicated to creating and communicating reports.

In addition, there is likely to be a reduction in the number of traditional onsite branch audits. The truth is that this is already happening and internal audit has been carrying out remote branch

audits rather than auditing onsite. However, the trend is set to continue as new technology allows internal auditors to gather and review more and more information remotely.

Off site

Contributing to this accelerating trend are document management techniques that allow for more information to be available in electronic formats (contracts, ID, etc.). This is likely to drive further

changes, such as entities only doing onsite visits when a risk or compliance flag is raised – impacting on the traditional concept of audit frequency. In future, low risk offices may not be visited in many years. But top management is likely to still want internal audit to evaluate branches, as these evaluations add significant value to management. So, one of the challenges will be to develop a single risk indicator for branches that groups together remote and onsite audit conclusions.

I also expect to see an increase in cross-functional audits, where the audit objective is not the branch, but a specific risk. Evaluations of the level of control for that specific risk will be reviewed across branches. This cross-functional approach may drive internal audit functions to radically change their organisation, deploying teams specialised in specific risks. This may mean the complete extinction of dedicated, branch network auditors. The downside is that the ability of the different audit teams to work together efficiently and not lose the integrated view of risk associated to the branch network.

Finally, there will be an increase in remote auditing, »

» and this will extend to areas other than just the branch network. Remote auditing has evolved tremendously to help financial entities evaluate risks in branch networks. However, the use of remote techniques for auditing other auditable entities in the audit universe has been very sporadic and mostly scarce.

develop remote auditing techniques to review other risks. Some key areas where this may be deployed are IT risks, capital and liquidity risks, and financial reporting risks.

There are plenty of practical challenges to deal with following the introduction of SMM including ensuring that internal audit is properly resourced, and has the right

“This cross-functional approach may drive internal audit functions to radically change their organisation, deploying teams specialised in specific risks”

This is probably due to the fact that remote auditing has been traditionally employed by internal auditors with a deep knowledge of branch risks and little understanding of other areas of risk. On the other hand, audit teams that review non-branch related risks have not had the opportunity, and do not have the knowledge or budget, to develop remote auditing techniques. Now that the remote auditing of branches is highly developed, it is time to dedicate resources and budget to

skills and technologies to meet the needs of its stakeholders. If they are successful, auditors will have moved much closer to fulfilling the role of trusted advisor than ever before. And while the SSM will obviously impact the financial services sector, there are likely to be lessons to learn from this experience for auditors working in other industries.

Click to read IIA Spain’s Challenges and expectations for the future of internal audit in banking and credit institutions.

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A view beyond numbers

The European Union has launched an initiative to boost the role of non-financial reporting in large businesses. Internal audit will be key to the project's success

“Non-financial reporting demonstrates responsible corporate behaviour, which can contribute to long-term business sustainability, promote a brand and please stakeholders,” said Igor Soltes MEP, vice-chair of the European Parliament’s budgetary control committee, at a recent ECIIA organised roundtable.

He said internal audit would play a key role in helping organisations benefit from non-financial reporting, which, he

said, would re-establish corporate trust among the public and drive both better corporate practice and competitive advantage.

Following the market reforms that the European Union introduced in the wake

of the financial crisis of 2007, the Directive on Non-Financial Reporting is seen as a further step to increase corporate transparency, recover trust and focus on long-term performance. The Directive only affects large »

“Internal audit will play a key role in helping organisations benefit from non-financial reporting”





Silvio de Girolamo

» public entities with more than 500 employees – that is about 6,000 companies across the EU. The goal is to encourage businesses to take a more holistic

“The role of the internal audit function has an increasingly strategic nature”

approach to their reporting, swapping the conventional, narrow concentration on financial performance for a perspective that looks beyond the numbers to the social and environmental impacts of doing business.

New approach

That will mean a change of approach for internal auditors too [See, *Key questions for auditors*]. Silvio de Girolamo, an ECIIA Board member, said at the roundtable, held in conjunction with *Parliament Magazine*, that the Directive would help auditors move the focus of their work towards prevention.

“There is no benefit for the company in just identifying what

is wrong,” he said. “The benefit for the company is to prevent the fire before it happens, and we are in the best position to do so because we are inside the

company – we don’t just manage the figures, we also manage the process and the risk in order to see what the best solution is.”

Girolamo said that the two words to focus on were integration and assurance. “Results can be limited, even within a company, so we need integration, and integration is needed to increase confidence and transparency in the company’s work and management,” he said.

Commenting on the Commission’s new Directive, he said, “We need to reinforce it with international law and harmonise with different geographical legal systems, giving greater transparency and trust to stakeholders who have

the long-term performance of a company in mind.” He said that between external and internal auditing, integrated assurance could contribute to a better vision and understanding of a company.

Value change

“At the heart of integrated reporting is the idea that the concept of value has changed, as has the way in which businesses communicate it,” Jonathan Labrey, chief strategy officer at the International Integrated Reporting Council (IIRC), said at the roundtable.

He told the audience that companies that only take into account their financial performance “are really losing out and exposing themselves to greater risk and not exploiting opportunities that cannot be found in balance sheets”.

“The role of the internal audit function has an increasingly strategic nature”, he said. “It is developing a role as a trusted advisor for boards on all matters pertinent to the activities of an organisation”.

While the challenge to creating the type of transparent, integrated

reporting that the Directive envisages are substantial, so are the potential rewards: a more balanced and long-term vision of wealth creation in Europe. Internal audit’s work in this area is critical to the success of that project.

Download the ECIIA white paper, *Non-financial reporting: building trust with internal audit*.

Enhancing integrated reporting provides boards and internal auditors with valuable insight into the role of internal audit in integrated reporting. The publication was produced by IIA France, IIA Netherlands, IIA Norway, IIA Spain, IIA UK and Ireland with the valuable contribution of IIA Global and the IIRC. Download here.

Non-financial reporting: key questions for auditors

Mentes Albayrak, Vice Chairman of IIA Turkey, answers some key questions on non-financial reporting



Mentes Albayrak

What should be included to non-financial reports?

All substantial matters that can effect an organisation's ability to create value over short, medium or long terms and that may have impact on organisation reaching its strategic

“Assurance providers need to understand the factors influencing the decisions of the intended report users and their needs”

goals need to be addressed in non-financial reporting.

Materiality is the threshold of importance to decide which issues are significant enough to be included in the report. An organisation's strategy, mission, vision and objectives

are all factors when deciding on materiality. Most importantly, the materiality of issues relevant to stakeholders is key in the scope of reporting and assurance. Assurance providers have to understand the factors influencing the decisions of the intended

report users and their needs.

After evaluating materiality, internal audit must assess how complete the relevant information is.

How can the quality of information provided in

the reports be evaluated?

The quality of information is an important issue for reporters and report users. However, there are difficulties in legislating for the quality of the reports. Especially as the EU Directive [on non-financial reporting] does not sufficiently address the information gap due to the lack of consistent and comparable information that will be reported. There is need for guidance on consistency, according to Mardi McBrien, Managing Director of the Climate Disclosure Standards Board (CDSB).

Internal auditors may take these principles as criteria for use in their evaluation of the quality of information disclosed in reports.

What are the challenges and how can internal audit meet them?

Non-financial reporting assurance is an evolving area, which »

GRI Framework

The GRI framework addresses five principles for ensuring the quality and appropriate presentation of reported information:

- **Balance:** The report should reflect positive and negative aspects of the organisation's performance to enable a reasoned assessment of overall performance.
- **Comparability:** Issues and information should be selected, compiled, and reported consistently. Reported information should be presented in a manner that enables stakeholders to analyse changes in the organisation's performance over time, and could support analysis relative to other organisations.
- **Accuracy:** The reported information should be sufficiently accurate and detailed for stakeholders to assess the reporting organisation's performance.
- **Timeliness:** Reporting occurs on a regular schedule and information is available in time for stakeholders to make informed decisions.
- **Clarity:** Information should be made available in a manner that is understandable and accessible to stakeholders using the report.

» faces some challenges. Internal auditors must exercise due diligence in dealing with these challenges, which include:

- Deciding on materiality
- Filling the competency gaps
- Auditing qualitative information, as the subject matter is not always quantitative, unlike financial information
- Auditing subjective information, as the subject matter is not always objective – again, unlike financial information
- Dealing with forward-looking information.

This type of assurance requires forward thinking, rather than a traditional backward-oriented approach. Internal auditors should look beyond of their organisations for external benchmarks, including to relevant sectors and industries to learn best practices

Using subject matter experts for technical areas and those that require specialist expertise is important, as is forming and coordinating multi-disciplinary teams to fill competency gaps and avoid duplication.

Internal auditors should be able to combine and boil down frameworks for non-financial reporting and assurance engagement standards into a single architecture. While dealing with materiality, qualitative or subjective information, such frameworks and standards should be used as defining suitable

“This type of assurance requires forward thinking, rather than a traditional backward-oriented approach”

criteria (for the intended users' purposes) and should be agreed by the interested parties. Personal judgment or experience cannot be taken as suitable criteria. If the subject matter is fundamentally subjective, internal auditors should evaluate carefully whether to accept the engagement or not.

Click here to read, *Non-financial assurance engagement guide for internal auditors.*

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