

European Governance

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Lessons in Governance

Special report on responses to the EC's consultation on corporate governance in listed companies

INSIDE: The risk of not seeing the risks, ECIIA's governance programme welcomes new members, conference round up and more



Not seeing the risks?

The oversight role of the audit committee includes asking management the right questions. This is particularly true when it comes to gaining assurance that risk management processes and internal control systems have been fully considered in the strategic and business planning processes and operations, according to the first in a new series of briefing notes on corporate governance from the ECIIA.

Yet one of the biggest risks that the audit committee and board face is the risk of not seeing the obvious threats until it is too late. Too many organisations only take the right decision on risk after disaster has struck. It's time to get more rigorous, says the note *The risk of not seeing the risks*. The board and the audit committee need to ensure that their organisation is familiar with all the many individual risks that they face, before they occur. That is a fundamental part of a comprehensive and effective risk management process.

While there is no "one size



fits all" way of identifying and managing risk, global needs and objectives for doing so are valid for every organisation. The processes and practices they adopt will depend on the size, nature and complexity of their entity.

Boards could start this process by asking a couple of basic questions, says the briefing. First, has a solid planning process been established by the audit committee that clearly calls for the structured identification of the principal risk factors? Second, and if "yes," how well-defined is the framework for categorising risks?

These questions can serve as a launch pad for all the

analyses that will follow to assess risk in the business. It must cover strategic, operational and governance risks, not just financial ones and it must be appropriate for the nature of organisation's specific business, objectives, processes and activities.

The briefing says that boards should understand how both changes in the wider business and social environment, as well as those taking part within the organisation, present new risks and opportunities when it comes to achieving their strategic objectives.

Adopting such a classification framework with good top down detail would enable management to use it as the basis for maintaining ongoing risk management assessment and management processes.

The briefing is the first in a series called *Insight and Oversight*, which present a range of issues to help board members and audit committee reflect upon their roles.

For a copy of *The risk of not seeing the risks*, click here.

Last chance to enrol for the ECIIA annual conference



IIA-Spain is hosting the 2011 ECIIA European Conference in Madrid. The conference runs from 19th to 21st October 2011 at the North Convention and Congress Centre of IFEMA in the city.

The theme of the conference is *Moving forward*. Delegates and speakers will have the opportunity to discuss topics such as e-crime, cloud computing, change and commitment management. There will be reflections on what to do after the crisis, which will take a practical approach to the key issues.

Keynote speakers include David L. Landsittel, chairman of COSO, Richard Chambers, president and CEO of IIA Global and Phil Tarling, president of the ECIIA.

Professional speakers from major global companies, including Ferrari, Telefónica, JP Morgan, SAP, Sanofi Aventis, Statoil, Poste Italiane, Santander Group will share best practice with delegates.

For information: www.eciia.eu

Promoting governance

Organisations operating in Europe face the constant challenge of applying sound corporate governance practice in a dynamic world. That's why the ECIIA is delighted to have recently received the support of Enel and Eni in helping it promote best corporate governance practice across Europe.

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Cloud cover



Cloud computing is helping to drive the growing need for international security control standards, in both the private and public sector, according to a study presented at the ECIIA's conference – *From clouds to clear sky* – held in Rome this July.

J Pinder and Dr. J Rigelsford's study analysed the various aspects of cyber security that are needed to develop an effective corporate security governance strategy. They found that while cloud computing offers great opportunities to businesses willing to embrace it, the technology also requires careful security risk management,

as well as the creation and implementation of new framework for control and governance.

The researchers, both from the University of Sheffield, highlighted the need for organisations to value information and analytics, communicate effectively across all levels of the company, and analyse the in different lines of the business.

The authors are the winners of a competition run by the ECIIA, Poste Italiane, Global Cyber Security Center and the European Electronic Crime Task Force. The results of a Europe-wide workshop on benchmarking

internal audit in the public sector was attended by more than 65 participants in May in Nuremberg, Germany.

The project was designed to help organisations understand how well their internal audit function is contributing to effective corporate governance.

The two-day event was the culmination of a major project organised by the internal audit department at the Bundesagentur für Arbeit and the World Association of Public Employment Services (WAPES).

For a full report of the event, click here.

Strategies for excellence

Delegates at the 2011 annual conference of the the European Commission's Internal Audit Service reflected on strategies for internal audit excellence at its two-day conference in

October 2011 in Brussels.

The conference focused on some key questions: Are internal auditors recognised as key agents of change by management? Do they give overall assurance on governance, risk management and control? Do they display leadership in their working environments? Are

they committed to continuous improvement in professional practices? And what constitutes the independence, power and authority of internal audit activities across the audit profession, particularly in the audit profession?

Speakers included European Commissioner Algirdas Šemeta, head of internal audit at the

European Commission Brian Gray, secretary-general of the European Commission Catherine Day, director directorate internal audit of the European Central Bank Klaus Gressenbauer and author of the *International Capability Model* Elisabeth MacRae.

For more detail of presentations: <http://bit.ly/r1n7Rv>



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Lessons in governance

The European Commission is consulting on corporate governance reform in listed companies in the hope that the turmoil that followed the most recent financial crises can be averted in future. Arthur Piper reports

Ten years ago, few would have imagined that corporate governance would play a vital role in the survival of the Europe Union. Yet today, as the national governments in the region work out how to save Greece from defaulting on its debts, creating the right corporate governance framework is regarded as a crucial step for the future stability of the EU – some would even argue, of the project of European integration itself.

The current crisis was triggered in 2008 by the collapse

of confidence in the banking sector. And while there have been several corporate governance initiatives in the EU aimed at exploring the reasons behind that failure, the most important and wide-ranging of these was launched in June last year with the European Commission's consultation on corporate governance in the financial sector.

In April this year, the EC followed this with another Green Paper on corporate governance in listed companies: *The European Corporate* »



» *Governance Framework.* The two papers can be read in tandem as a blue print for the future of corporate governance in Europe and the future of the eurozone. As the EC says in the document: “Corporate governance and

should play a central role in the future governance of corporations operating in the EU. Crucially, that means that the board should both understand the nature of the risks their business engages in, and be prepared to manage it accordingly.

“Too many businesses had poor risk management procedures in place, or failed to take responsibility for the way that their companies dealt with risk”

corporate social responsibility are key elements in building people’s trust in the single market.”

In the most recent consultation paper the Commission focuses on three particular areas: boards of directors, shareholders and the quality of corporate governance statements.

Robust

But of central importance to each of these issues, is the question of how risks should be managed and reported on. In its response to the EC, the ECIIA argues that robust risk management practices

“The board has many means to ensure proper oversight of the risk management process,” says Carolyn Dittmeier, the incoming president of the ECIIA. “This includes applying efficiently the three lines of defense model and approving the risk profile implied in its strategic plans.”

This process would also involve the corporation properly monitoring its system of risk management and internal control so that it is effective in identifying risks and responding to them in relation to the level of risk the company has taken on – in line »

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» with its risk profile, she says.

While the ECIIA's suggestion sounds straightforward in practice, in reality there are a wide variety of companies and no single way of managing risk would suit them all.

"There is no single way to manage risks," says Dittmeier. The ECIIA is urging the EU to take account of the size of listed companies in its reforms so that small and medium sized enterprises are not overwhelmed with reporting requirements that are simply not suitable for the scale of their businesses.

Principles

However, in its submission to the Green Paper, the confederation writes: "There are certain core corporate governance principles and measures that should be applicable to all, and be oriented to clear outcomes." Getting the balance between enabling free enterprise and managing risk will be one of the EU's central challenges.

But if there is no one way of managing risk, how such enterprises tackle the issue? "We suggest that it would be helpful if the EU recommended companies

to adopt a risk management framework or methodology appropriate for the company and to disclose to their shareholders the framework of methodology they have chosen," says Dittmeier.

Frameworks that can be

"There are certain core corporate governance principles and measures that should be applicable to all, and be oriented to clear outcomes"

helpful include the Enterprise Risk Management Integrated Framework of the Committee of Sponsoring Organisations of the Treadway Commission ("COSO ERM" or "COSO2"). This is a key international document that describes the components of a good risk governance framework: and the ISO31000 standard issued by the International Standards Organisation is a key reference for guidance on implementing risk management principles.

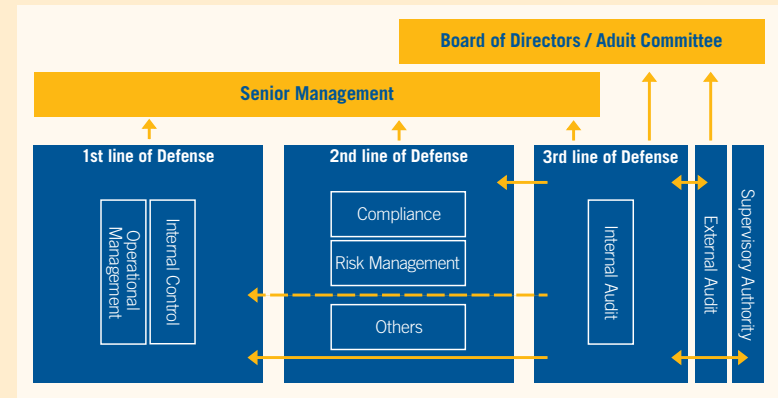
While the ECIIA believes that EU recommendations should

leave the company free to choose the framework it wishes, it should encourage each corporate to adopt such a framework.

In fact, a recent report by the Reflection Group on the future of EU company law has noted

the benefits to corporations of adopting a well-defined risk management framework. It says that the successful implementation of an enterprise risk management model can both affect the likelihood and consequences of risks materialising, and result in better informed strategic decision-making, successful delivery of change and increased operational efficiency. Other benefits include reduced cost of capital, more accurate financial reporting, competitive advantage, improved perception of the company, »

Three lines of defense model



- As a first line of defence, operational management has ownership, responsibility and accountability for assessing, controlling and mitigating risks.
- As a second line of defence, the risk management, compliance and similar functions facilitate and monitor the implementation of effective risk management practices by operational management and assist the risk owners in reporting adequate risk related information up and down the organisation.
- As a third line of defence, the internal auditing function, in support of the audit committee will, through a risk based approach, provide assurance to the organisation's governing body and senior management, on how effective the organisation assesses and manages its risks, including the manner in which the first and second lines of defence operate. This assurance task covers all elements of an institution's risk management framework: i.e. from risk identification, risk assessment and response to communication of risk related information (throughout the organisation and to senior management and the governing body).

» better marketplace presence and, in the case of public service organisations, enhanced political and community support.

Enterprise wide

Dittmeier argues that an enterprise risk management system is essential towards good corporate governance because it is geared towards helping an organisation achieve its objectives. It ensures focus is maintained on the strategic goals of the business, and on its operations – so that resources are used effectively and efficiently. In addition, the framework enables reliable reporting and effective compliance with laws and regulations.

The main ECIIA's response to

the Green paper also advocated the increasingly recognised three lines of defense model as a benchmark for future regulatory guidance. (See *Three lines of defense model*).

“This model is rapidly gaining universal recognition and is consistent with the guidelines already applied in the financial sector,” says Dittmeier.

The EC's consultation process ended in July and now businesses will have to wait to see what reforms the Commission will recommend. While its final decisions are unlikely to affect the outcome of the current financial turmoil sweeping Europe, they could very well avert a similar catastrophe striking again. ■

“An enterprise risk management system is essential because it is geared towards helping an organisation achieve its objectives”

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Regulation is not the way forward

More regulation at a European level is not the way to improve corporate governance standards outside the financial sector, argues an association for publicly quoted companies

The financial crisis exposed poor risk management and weak corporate governance at Europe's banks and insurance companies. But does the rot run deeper? Do corporate governance standards in other business sectors need to be improved too?

The European Commission has reserved judgement on those questions, for now. Earlier this year it published a Green Paper asking for views on what reforms – if any – are needed to governance practices outside of the financial sector.

That first step does not imply further regulatory action. But the Commission's review has

prompted fears that, in a belated move to fix the governance rules as they relate to banks, it will impose unnecessary rules on listed companies in business sectors that had nothing to do with the crisis.

Concern

That is certainly the concern at EuropeanIssuers, an organisation that represents companies with shares listed on Europe's various stock markets. "The current financial crisis has obliged Europe to re-think its regulatory system in order to avoid similar impact on the real economy in the future," it said in its formal response to the Green paper.

"Listed companies, who had been subject to waves of regulation a few years before, are now concerned that they may be affected negatively by these regulatory reforms."

The prospect of more regulation is a worrying one, says Susannah Haan, the organisation's Secretary General. European companies are already over-regulated when it comes to their governance models, she believes. This is undermining the appeal of Europe's financial markets.

Europe fell to third place in terms of the number of new global listings last year. It's no surprise that Europe should come behind the US, says »



Secretary General, EuropeanIssuers Susannah Haan

» Haan, but the fact that Greater China took second place could be a sign of a damaging trend. The Far East is becoming a more attractive business location, as the region's economies weather the crisis better than those of the developed West. Europe should be finding ways of encouraging companies to stay listed on its markets, not dreaming up new regulations that tip their decision to leave, she believes. "Policymakers need to see corporate governance within the context of global competitiveness," she says.

Her organisation's member companies do not necessarily disagree with some of the governance goals floated in the Green Paper, but they are concerned at the prospect of politicians trying to achieve them via formal regulation. "We would like to see sensible and balanced regulation that will not be costly and burdensome without any benefits," she says.

Diversity

Gender diversity in the boardroom is an example. It might be a good idea for companies to appoint more women to boardroom roles, and it's valid for the Green Paper to ask

why this doesn't happen more often, says Haan. But the way to increase gender diversity in the boardroom is to improve the pipeline of women working in senior management roles, increase the availability of mentoring, and create a central source of information and support for potential women candidates, she argues. Setting quotas for the number or proportion of women in boardrooms – an idea the Commission is seeking views on – will not solve the issue, Haan believes.

“Corporate governance should not be used to implement social and societal policy issues”

Generally, Haan says her organisation's members are opposed to the idea of the Commission using corporate governance regulation to achieve wider policy objectives. The Green Paper says that companies must demonstrate utmost responsibility not only to shareholders and employees but also towards society at large – EuropeanIssuers disagrees.

“Governance is about the internal dynamics of companies and the responsibility of their different stakeholders,” its response states. “Corporate governance should not be used to implement social and societal policy issues.”

Indeed, the Commission ought to scale back its involvement with corporate governance questions, Haan argues. The Green Paper is useful because it prompts debate and gives the different parties involved in governance an

“opportunity to talk and learn”, says Haan. But this is not an arena where pan-European standards are needed. “I'm very strongly of the belief that national codes are much more effective,” she says.

“Corporate governance is so tied up with the culture of the country and its national company law,” Haan explains. “You can't just ignore that and pretend they are all the same.

Underneath, the way companies behave is always different because it is grounded in national culture.” Governance codes grow out of the background in which companies operate, she continues. The best ones are have been written with local corporate input, based on real life experience in the local market.

So her organisation does not support pan-European action on board composition or the separation of the roles of CEO and chairman. It's reasonable, Haan argues, for a governance code to suggest that a board use outside recruitment consultants as a way of increasing the transparency of the appointment process. “But deciding how boards should be run is not valid.”

Haan is also concerned about the prospect of greater regulatory influence over the role of audit committees. Their workload and formal responsibilities have increased significantly in recent years, Haan says: good directors might be deterred from joining audit committees if the trend continues. Moreover, locating so much responsibility for assurance, risk management and control with one group of people is unrealistic, she says, because that is not how

large organisations operate, while some smaller companies do not have an audit committee at all.

“The Commission should take greater interest in the work and quality of the other assurance functions with deeper roots in the organisation, such as internal audit,” Haan argues. EuropeanIssuers and the ECIIA might have some common views on this issue, she says, in which case they could work together to help the Commission better understand how different companies operate.

Comply or explain

EuropeanIssuers is a firm supporter of the “comply or explain” approach to governance, whereby companies are expected to follow an agreed code and explain any areas where they have not complied.

The Green Paper criticises the operation of this principle, arguing that too often companies have given poor explanations of non-compliance or failed to explain themselves at all – all without any complaint from shareholders.

Haan accepts that companies may need to sit down with their shareholders to discuss what they want to see by way of »

» explanations. “Those of us in companies should think about how we can share best practice across Europe in communicating our explanations as to why we have chosen not to follow particular recommendations of a code,” her organisation’s submission says. Explanations should then be judged by shareholders, who can vote against company resolutions if they are not happy.

Even so, such an explanation needs to be understood as an act that complies with the code, not one that breaks it, the submission says. And whatever shareholders make of the explanation, “We do not support a role for regulators in monitoring individual governance decisions,” says the submission.

Operation of the comply or explain principle isn’t the only issue where companies need to have better dialogue with their investors, European Issuers believes. “There are misconceptions on both sides which we need to try to overcome,” says Haan.

Shareholders

In Europe, this can be difficult. It is not always easy to identify shareholders across borders. The Commission raised this as a problem in its Green Paper, a move that Haan welcomes. She also supports the idea of investors disclosing their voting policies, so that

companies can better understand their shareholders’ approach to governance issues. This would help to ensure greater understanding ahead of any possible areas of disagreement, she says.

Haan says her overall message to the Commission’s policymakers is that they should not act in haste. There is a clear public demand for “something to be done” about the causes of the financial crisis. And for politicians keen to show evidence of action, imposing a “one-size-fits-all” European corporate governance model is a lot easier than sorting out the complicated risk management and capital reserve issues that bedevil the banking sector, she says.

But introducing new governance regulations without clear evidence of their benefits would be a mistake, Haan believes. “My headline response to the Green Paper is this: if you want to regulate, make sure there is going to be a positive impact, be sure that you will somehow improve behaviour,” she says. “You need to understand the different ways in which people from Europe’s different member states think and work. Any governance model needs to succeed in the real world. It has to work with the grain of human nature.”

For more information about EuropeanIssuers:
www.europeanissuers.eu

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