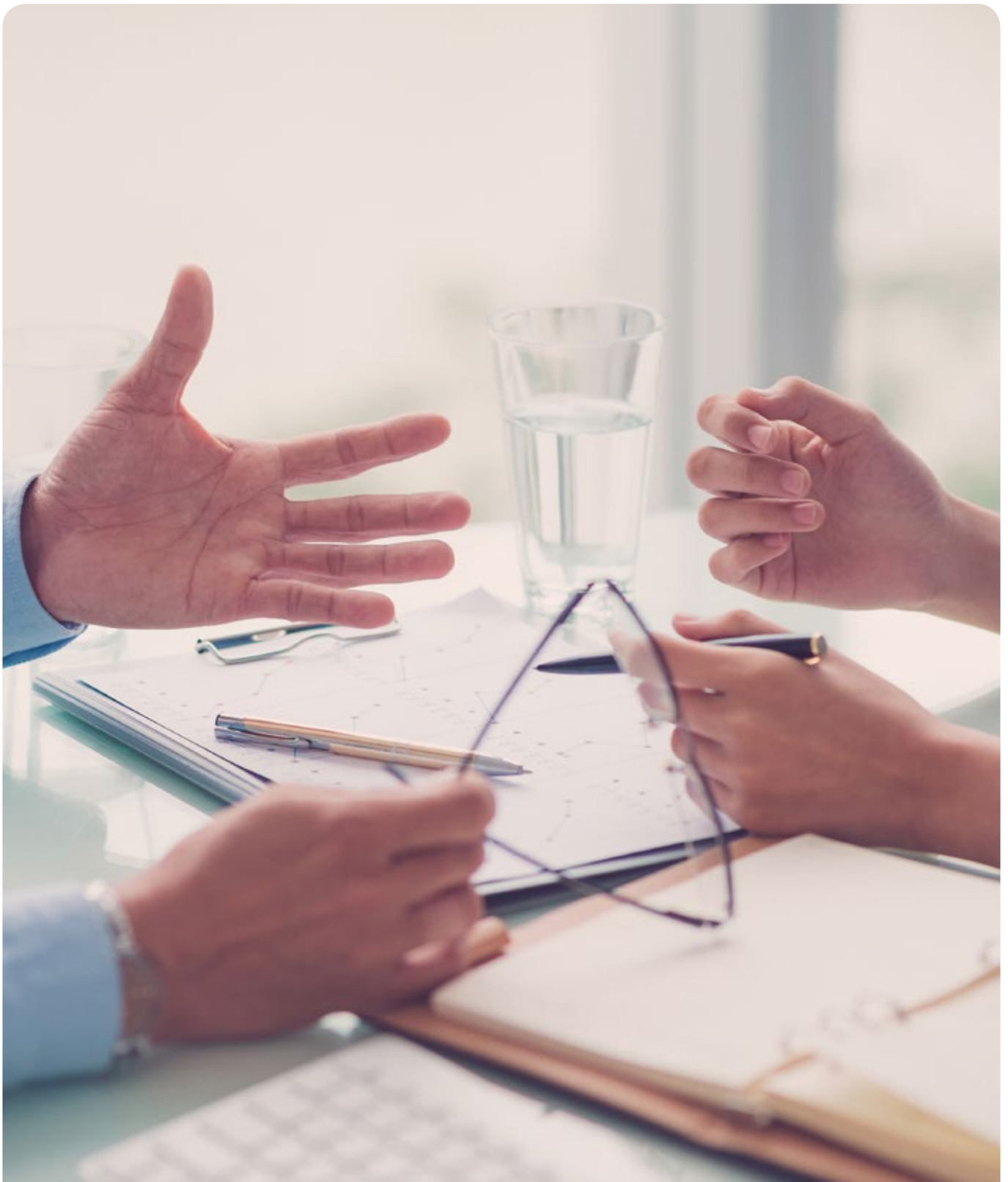




Non-Financial Reporting: Building trust with internal audit





Enhancing Governance through internal audit

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1

Executive Summary



The European Confederation of Institutes of Internal Auditing (ECIIA) is the professional representative body of 36 national institutes of internal audit in the wider geographic area of Europe and the Mediterranean Basin. ECIIA's mission is to be the consolidated voice for the profession of internal auditing in Europe.

On September 29th 2014, the European Council formally adopted the Directive on Non-Financial Reporting and the European Commission is preparing non-binding guidelines on the methodology for this reporting. These new requirements reinforce existing national laws in some countries and professional practices.

The benefits of this reform in terms of greater transparency, trust and long term performance will depend on the quality of the reports issued.

There is a need to define accountability and determine a clear mechanism for oversight assurance in respect of the reporting of this information in order to meet the objectives of greater transparency and better corporate governance.

Internal audit, as the third line of defence in organizations is one of the cornerstones of corporate governance. Depending on the maturity of the process of non-financial reporting, internal audit may provide assurance about the reporting or function as an adviser. This paper describes the various roles that internal auditors may play and recommends an integrated approach through the coordination of the various internal and external assurance providers.



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Objectives of the guidance and context



06/02/2013

In its resolutions of **6 February 2013** on, respectively, ‘Corporate Social Responsibility: accountable, transparent and responsible business behavior and sustainable growth’ and ‘Corporate Social Responsibility: promoting society’s interests and a route to sustainable and inclusive recovery’, the European Parliament acknowledged the importance of businesses divulging information on sustainability such as social and environmental factors, with a view to identifying sustainability risks and increasing investor and consumer trust.

29/09/2014

On **29 September 2014**, the European Council formally adopted the Directive on Non-Financial Reporting with the objective of increasing EU companies’ transparency and performance in respect of environmental and social matters and thereby contributing effectively to long-term economic growth and employment.

The amendment proposed by the European Commission to the existing accounting legislation (Directive 2013/34/EU) will improve transparency of certain large companies on social and environmental matters especially in countries where such reporting does not exist yet. Companies concerned will need to disclose information on policies, risks and outcomes in respect of the environment, social and employee related matters, the respect of human rights, anti-corruption and bribery issues as well as diversity on the board of directors.

At company level, disclosing this information will imply better control and management. Ultimately, companies will realize benefits over time including better performance, lower funding costs and reduced impact of business disruptions as well as experiencing better relations with consumers and stakeholders. Investors and lenders will benefit from a more informed, comprehensive and efficient basis for investment decisions.

The Directive gives companies significant flexibility to disclose relevant information either in a way that they consider most appropriate in the annual report or in a separate report. Companies may use the international, European or national guidelines they consider most appropriate (for instance, the UN Global Compact, ISO 26000, the German Sustainability Code or the Global Reporting Initiative).

Currently the concept of «comply or explain» is applicable to the reporting of the companies concerned.

By 2016

The European Commission aims to prepare **by 2016** non-binding guidelines on the methodology for the reporting of non-financial information.

2016

In **2016**, the Directive should be translated into national law and the first publication of non-financial information is expected in 2017 for all European countries.

2018

In **2018**, The Commission plans to release a review report with possible further legislative proposals.

2011-2014

The new COSO **2013** framework has also included the concept by defining a general reporting dimension in place of an exclusively Financial Reporting dimension.

The objective is to allow a review of the company's total performance and value creation, not just financial information as was addressed in the previous document "A renewed EU strategy **2011-14** for Corporate Social Responsibility".

07/2018

It is also important to note that the Commission is examining the possibility of introducing an obligation requiring large undertakings to produce, on an annual basis, a country by country report containing tax-related information such as profits made, taxes paid on profits and public subsidies received. Conclusions in respect of this new requirement are due in **July 2018**.

These new requirements reinforce existing national laws in some countries and professional practices. All these initiatives target the provision by companies of greater transparency and increased volume of information but should not create excessive administration burden.

The ECIIA believes that the integration by companies of financial, environmental, social and other information in a comprehensive and coherent manner is the way forward*.

In this context, internal audit has a crucial role to play. Internal audit's remit goes beyond Financial Reporting and related controls, to providing assurance over non-financial information as well as the systems, policies and controls supporting the production of this information and specifically in the areas of sustainability activities and reporting, and non-financial communication.

ECIIA's objective with this guidance is to clarify the different roles that internal audit may play in the implementation of these new directives and how it can add value to organizations and assist the Board in the fulfilment of its new duties.

Internal audit is in a unique position to take a 'helicopter' view of an organization. It provides independent assurance on the effectiveness and efficiency of controls, risk management and governance. Internal audit has a broad remit and part of its assurance process is to ensure that all elements of business activity align and are consistently achieved. It also sees across silos by placing reliance, where appropriate, on the work performed by the first and second lines of defence.

* Extract from Internal audit Value Proposition, IIA France-Netherlands-Norway-Spain-UK & Ireland, March 2015

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Sustainability: the background and European definition of the concept



The concept takes its origins in sustainable development which may be defined as the ability to meet the needs of present generations without jeopardizing the ability of future generations to meet their own needs.. In other words, sustainable development aims to provide a better quality of life for everyone, both now and for generations to come. It offers a vision of progress that integrates immediate and long term objectives, local and global action, and regards social, economic and environmental issues as inseparable and interdependent components of human progress

In the communication from the Commission of the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions entitled “A renewed EU strategy 2011-14 for Corporate Social Responsibility “, the European Commission has put forward a new definition for corporate social responsibility «the responsibility of enterprises for their impacts on society».

In order to fulfill their corporate social responsibilities, companies should have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders with the aim of:

- maximizing the creation of shared value for owners/shareholders, other stakeholders and society at large
- identifying, preventing and mitigating possible adverse impact from operations.

Some European states introduced the disclosure of sustainable reporting before the European Directive was approved i.e. UK, France, Spain, Sweden, Denmark and Norway.

Sustainability awareness must start at Board level. The issues, e.g. climate change and human rights, have a major potential negative impact but can also represent substantial opportunities. Sustainability must be factored into the business strategy as an additional layer over and above operational aspects.

Furthermore, the Board and management must define the information to be reported publicly and establish the roles and oversight responsibility for sustainability activities, including reporting and definition of the assurance model.

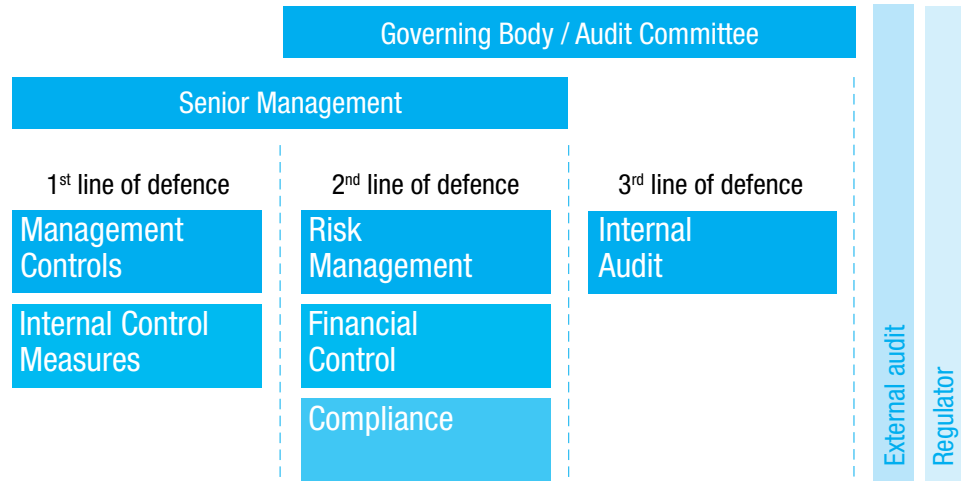
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The 3 lines of defence and the 3 dimensions of sustainability



ECIIA promotes the 3 lines of defence model to distinguish the role of each function in the reporting process.

The Three Lines of Defence model



The first line of defence is operational management which has ownership, responsibility and accountability for non-financial reporting.

The second line of defence includes financial control, risk management, compliance and similar functions which facilitate and monitor the implementation of an effective Non-Financial Reporting process by operational management and assist the operational units in reporting relevant material information both upwards and downwards within the organization.

The third line of defence is the internal audit function which provides independent assurance to the organization's Governing Body and Senior Management. Regarding non-financial reporting process and disclosures, internal audit can provide assurance that the risks are being effectively mitigated and suitable controls have been implemented.

There is a need for an oversight body to take responsibility for the company's work on non-financial reporting. ECIIA recommends that internal audit interacts with this body and provides it with independent assurance.

The reporting process passes through the various organizational levels before being received by the Governing Body.

Although External Audit issues an audit report on the financial statements, its role in respect of non-financial information is not so clear. Indeed it may play various roles depending on the details of the audit contract with the company and requirements in national legislation. Currently the Directive has no requirement regarding external audit's role in respect of non-financial information.

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The Governing Body should be involved in defining key elements of the process, such as:

- the level of assurance needed over reporting
- the materiality level for the non-financial information
- the type of information communicated (e.g. strategic information)
- the framework to be adopted to collect the information (in cooperation with the 2nd and 3rd Line of Defence).

This new reporting covers 3 main areas: economic, social and environmental information. Below we illustrate the role of each line of defence in the collection and preparation of this new information.

	Economic	Environmental	Social
1 ST LINE	They are responsible for collecting the data, implementing the anti corruption, bribery procedures. They monitor the process and make corrective actions if needed.	They are responsible for collecting the data about environmental issues, define the KPIs. They monitor the process and make corrective actions if needed.	They are responsible for collecting social information. They monitor the process and make corrective actions if needed.
2 ND LINE	Compliance develops the process to collect the data. They define the reporting format and process. They control the process and assist the 1 st line.	HSE defines the process to collect the relevant data. They define the reporting format and process. They control the process and assist the 1 st line.	HR defines the process to collect the data. They define the reporting format and process. They control the process and assist the 1 st line.
3 RD LINE	They provide assurance on the organization's effectiveness in assessing and managing its risks and related internal control systems, including the manner in which the 1 st and 2 nd lines operate.	They provide assurance on the organization's effectiveness in assessing and managing its risks and related internal control systems, including the manner in which the 1 st and 2 nd lines operate.	They provide assurance on the organization's effectiveness in assessing and managing its risks and related internal control systems, including the manner in which the 1 st and 2 nd lines operate.

As for the other processes, coordination between the different lines is key to setting up a reporting process that is both efficient and effective and the Governing Body must consider the implementation of integrated management, reporting and assurance as described below.

The implementation of the new Directive will impact organizations in widely differing ways. Some have already established reporting on non-financial information whereas others have not. Indeed some might decide not to implement the new reporting requirements and prefer to explain their reasons for not complying.

Assurance over non-financial information is a developing area and internal auditors are in a good position to provide it as they have experience in carrying out assurance engagements in accordance with professional standards. However, there are practical challenges. Internal auditors should review their skill sets to be in a position to provide assurance on specific areas.

Use of experts or outsourcing specific areas should be considered as well as forming multi-disciplinary teams.

* The International Professional Practices Framework (IPPF) is the conceptual framework that organizes authoritative guidance, promulgated by The IIA. It provides internal audit professionals worldwide with authoritative guidance. More info on www.theiia.org

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Internal audit may play various roles in the implementation process.

	Sustainability maturity	Internal audit focus
Leader	Sustainability is integrated in the strategy to create value	Contribution to integrated assurance on sustainability with independent assurance review
Mature	Sustainability risks are managed and regulatory requirements are met	Integration of sustainability in the risk assessment and in the audit plan
Follower	Regulatory requirements	Sustainability activities included in the internal audit charter

As for the other processes, coordination between the different lines is key to setting up a reporting process that is efficient and effective and the Governing Body must have an integrated thinking and consider the implementation of integrated management, integrated reporting and integrated assurance as described below.



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Integrated Management, Integrated Reporting and Integrated Assurance



The evolution is not only towards non- financial reporting but also towards integrated assurance. As part of the transparency objectives, organizations will really benefit from the European Reform if they adopt integrated thinking : integrated management, integrated reporting and integrated assurance.

Assurance over non-financial information is critical for creating stakeholder confidence. Lack of confidence in the information disclosed in non-financial reports may act as a barrier to the use of such information.

Assurance is a process and must be based on sufficient, reliable information, be performed independently of the underlying processes and be evidenced by a report.

The International Integrated Reporting Council (IIRC)* states that “reliability is enhanced by mechanisms such as robust stakeholder engagement and independent, external assurance.”

However, it may be difficult for external assurance providers to have sufficient knowledge about the various Content Elements** in order to provide reasonable assurance. Such assurance will require a substantial change in the scope, knowledge, expertise and skill sets of external assurance providers.

Assurance is not an outcome or a report but a process. Key features of assurance include:

- measurable and approved framework and set of controls
- risk based approach
- existence of sufficient, reliable, relevant and useful information
- independent assessment of the underlying processes by competent and objective individuals, based on a set of widely recognized standards
- documentation in a report or written conclusion.

This is why we recommend coordination between internal assurance providers (internal audit, risk management etc.) with external assurance providers in the validation process.

The IIA has issued guidance to explain the way the coordination may be organized and introduced the concept of assurance mapping***

The coordination of the different players will facilitate the assurance given and ease communication with the Governing Body.

Integrated reporting is defined by IIRC*: «The integrated reporting is a concise communication about how the organization’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term. It is a process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time».

In order for integrated reporting to be seen as a reliable instrument for assessing sustainability, organizations will need to provide coordinated assurance regarding the information reported.

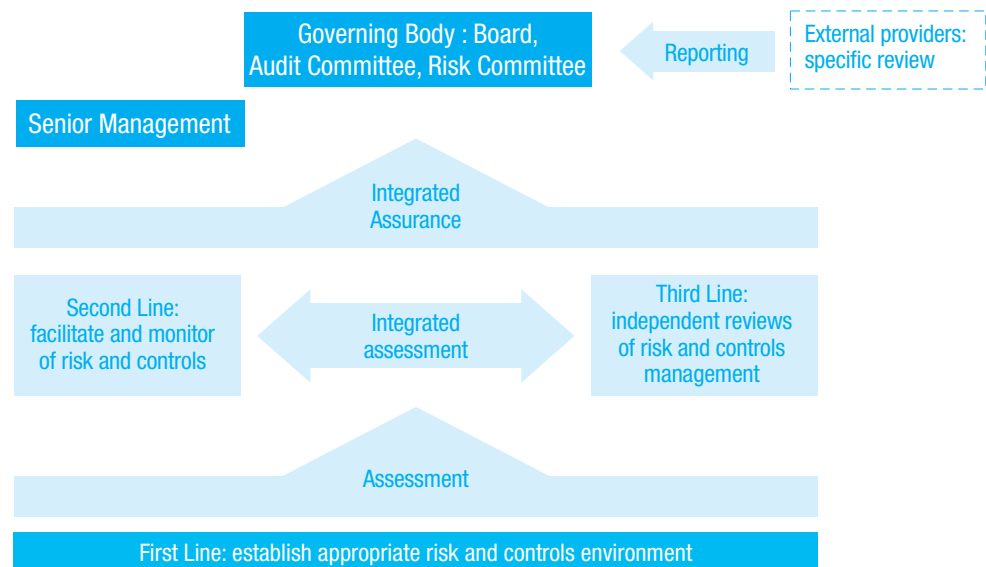
* IIRC: The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. Together, this coalition shares the view that communication about value creation should be the next step in the evolution of corporate reporting. information on www.theiirc.org.
** Extract from The International Integrated Reporting Framework', IIRC, available on www.theiirc.org
*** Practice advisory 2050-2 : assurance maps . They are part of The International Professional Practices Framework (IPPF) : the conceptual framework that organizes authoritative guidance, promulgated by The IIA. It provides internal audit professionals worldwide with authoritative guidance. More info on www.theiia.org

The Global Reporting Initiative (GRI)* has issued reporting guidelines to serve as a generally accepted framework for reporting on an organization’s economic, environmental and social performance. It is designed for use by organizations of any size, sector or location but does not include the concept of integrated reporting.

The importance of assurance over these reports has been recognized by GRI and in their guidelines they recommend the use of external assurance but do not require the external auditors to prepare a report that confirms the information has been prepared in accordance with the GRI Guidelines.

They recognize that organizations will have systems of internal control and may therefore request their internal audit function to review the integrity and credibility of the reporting.

Integrated assurance build up



Integrated assurance relates to the coordination of external and internal assurance providers in order to achieve a level of assurance that best balances cost and utility with market and regulatory requirements.

The various players will collaborate in order to define standards and provide guidance. This collaboration will result in the harmonization of risk views amongst the providers. The Governing Body will need to define the level of assurance required and will receive coordinated assurance in addition to integrated reporting.

Internal audit can play an important role in this process according to the IPPF** 2050 Coordination: «The Chief Audit Executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts».

* GRI : The Global Reporting Initiative (GRI) is a leading organization in the sustainability field. GRI promotes the use of sustainability reporting as a way for organizations to become more sustainable and contribute to sustainable development.
 ** The International Professional Practices Framework (IPPF) is the conceptual framework that organizes authoritative guidance, promulgated by The IIA. It provides internal audit professionals worldwide with authoritative guidance. More info on www.theiia.org

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The role of internal audit in the implementation of European directives



Companies are facing a host of pressures to comply with a myriad of complex reporting standards and there are increasing concerns about the accuracy of the reported information. Internal audit can play a key role by providing the audit committee with an assessment of the quality of the processes and controls used to generate this information.

Standard 2100* of the International Standards for the Professional Practice of Internal Auditing requires internal auditors to contribute to governance, risk management and control processes using a systematic and disciplined approach.



“Whether internal auditors are providing assurance or functioning as advisers, their big picture perspective can make a significant difference in a vast range of organizational initiatives and activities”

R. Chambers, President and CEO IIA Global



“Internal audit is uniquely situated within an organization to provide insight on and support the implementation of integrated reporting. Internal audit:

- *is familiar with process implementation in the organization*
- *can affect consistency of communication of metrics across business units*
- *provides assurance to increase the credibility of metrics in the non-financial report*
- *offers insight on potential risks to the organization*

*has a «seat at the table» from which it can influence the adoption of Non-Financial Reporting to improve and strengthen communications with internal and external stakeholders” ***

With its organizational independence and sound understanding of the business and its environment, internal audit can play several roles depending on the maturity of the reporting processes and on the road map of the organizations in respect of non-financial reporting.

The forward looking nature of integrated reporting gives the potential for internal audit to take a strategic role in assessing the risks for an organization in the short, medium and longer term and the benefits/opportunities of sustainability.

For organizations in the process of implementing the new reporting, or at an early stage of implementation, internal auditors may rather play an advisory role. They would audit the change management program and provide advice on the extent to which the aims of the program are likely to meet the reporting needs of the business.

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** Extract from Internal audit Value Proposition, IIA France-Netherlands-Norway-Spain-UK & Ireland, March 2015

This role might include inter alia:

- explaining to and training key players about the new directive and integrated thinking
- providing recommendations (gap analysis) for the implementation of the Directive to the Governing Body and/or Senior Management
- promoting coordination and the benefits of coordinated thinking
- assessing process design and controls (with the second line)

For those organizations that have already implemented non-financial reporting, internal audit will play an assurance role but can still play an advisory role for the risk assessment, e.g. by facilitating risks identification sessions

The assurance role will encompass inter alia:

- assessing the risks of the processes involved
- defining the reliance on the other lines
- assessing the reporting process including internal controls, governance and risk issues
- ensuring the effectiveness and efficiency of the process
- making recommendations to reduce the risks of incorrect data, to protect and create value.

In organizations with subsidiaries, it is important to recommend a harmonized approach and methodology in order to consolidate common information.

As the Directives will be translated into local law variations may arise in requirements between countries. This may create difficulties for cross border groups.

The important thing is assurance as a whole and therefore harmonization and coordination are key to the future.

ECIIA recommends the implementation of the integrated thinking approach.

Internal audit may play an important role in the implementation of this approach.

As a cornerstone of good governance, internal audit may help by :

- assessing roles and responsibilities across the different committees (audit, risk etc.)
- harmonizing governance, risk management, risk control functions, processes and terminologies in the organization
- enhancing assurance and a sound risk and control environment

In terms of risk management, internal audit may help by:

- assessing the roles and responsibilities across the 2nd and 3rd lines of defence
- harmonizing the risk frameworks: including risk universe, risk taxonomy, harmonization of rating scales, coordination of reporting and issue tracking.

In terms of internal controls, internal audit may help by:

- increasing ownership of internal control and risk in the first line of defence (business)
- reducing granularity (focus on main risks and key controls)

In conclusion,

Internal audit may play various roles in the implementation of the new Directive: from an advisory to an assurance role or even both. They may also assist companies in the implementation of combined assurance.

It is important that the role and responsibilities are clearly defined by the Oversight Body who are ultimately accountable for corporate governance.



About ECIIA

The European Confederation of Institutes of Internal Auditing (ECIIA) is the professional representative body of 36 national institutes of internal audit in the wider geographic area of Europe and the Mediterranean basin. The mission of ECIIA is to be the consolidated voice for the profession of internal auditing in Europe by dealing with the European Union, its Parliament and Commission and any other appropriate institutions of influence and to represent and develop the Internal Audit profession and good Corporate Governance in Europe. The Primary objective is to further the development of corporate governance and internal audit through knowledge sharing, key relationships and regulatory environment oversight.

www.ecija.eu



Thank you

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