“No thanks” to more reform

Interview: MEP Ashley Fox wants a moratorium on corporate governance reform until the recent slew of new rules and regulations have bedded in.

INSIDE: New guidelines from the Global Reporting Initiative herald a small revolution in sustainability management, European Parliament approves audit reform, more protection needed for internal audit whistleblowers and much more.
European Parliament approves audit reform

The audit sector faces its biggest shake-up as MEPs vote through a raft of measures that aim to improve investor confidence in financial information.

The European Parliament passed proposals in April that are designed to tackle weaknesses in the external audit market and that could erode the hold of the so-called Big Four audit firms that dominate the business.

Among a raft of measures, companies will be required to rotate audit firms every ten years. Public interest entities, such as banks and publicly listed companies, will only be able to tender to extend the audit tenure once. They will be encouraged to adopt joint auditing arrangements with two or more firms.

“Even though some of the measures adopted are not as ambitious as in the Commission’s proposals, I am very satisfied with the outcome.” Internal Market and Services Commissioner Michel Barnier said after the vote. “The spirit of the reform is intact, and it will have a major impact for the broad community of stakeholders that rely on the quality of statutory audits.”

There are also restrictions on the provision of non-audit services to public interest entities by their external auditors. Areas perceived to entail conflicts of interest have been “black-listed,” including internal audit, some tax advisory work and services linked to financial and investment strategy. In addition, a cap on the provision of “non-audit” services is set at 70% of audit costs.

There are also several reforms to the way that companies will need to handle the selection process and to boost external oversight of the market.

For further details on the amended Directive on Statutory Audit and the Regulation on specific requirements regarding the statutory audit of public-interest entities, click here.

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Getting to grips with reform

Recent amendments to the 8th EU Company Law Directive on how annual financial statements should be prepared and how the audit market is to be reformed could have wide-ranging implications for corporate governance, risk management and internal audit.

ECIIA and FERMA (Federation of European Risk Management Associations) have launched a joint initiative to help companies get to grips with the issues that these changes pose to business.

“Companies have to be prepared for the additional transparency, extra reporting requirements and responsibilities the directive now requires,” ECIIA President Thijs Smit says. “We are working with FERMA to produce guidance to executive management and boards about what it means to them.”

These changes fall on the shoulders of boards of directors and audit committees under Article 41 of the 8th Directive.

The ECIIA and FERMA working group will also be looking at how national governments of the region’s 28 countries have transposed the directive into law and identifying any discrepancies in their interpretation of its provisions.

The work builds on collaboration between the two bodies in 2010, which resulted in the publication Guidance on the 8th EU Company Law Directive, article 41. That paper urged directors to adopt an enterprise-wide approach to risk management in their businesses.

Under article 41 of the directive, audit committees should “monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems”.

Better protection for internal auditors

Chief internal audit executives need better protection from threats, poor treatment and potential terminations of contract to strengthen their role in the fight against money laundering and terrorism, ECIIA has told the European Parliament.

In its response to the European Parliament’s consultation on a new directive to tackle these issues, ECIIA says that the directive should give explicit protection to auditors who play a crucial role in bringing wrong-doing to the board, executive management, the regulators and the public.

“The directive should make it clear that chief audit executives should receive all possible protection against threats, adverse treatment and consequences – such as the termination of their contract of employment,” ECIIA President Thijs Smit says. “Everything possible should be done to strengthen their role, position and independence.”

That should include the provision of free legal aid, he added.

High profile internal audit whistle-blowers, such as Cynthia Cooper who discovered a $3.8bn black hole in WorldCom’s accounts in 2002, often come under intense pressure and bullying to make them conceal the truth.

Given the central role that internal auditors play in uncovering unethical behaviour, ECIIA urged the European Parliament to amend the directive to provide them with explicit protection.

To read the ECIIA response, click here.
Clarify auditors’ working relationships

While public sector auditors and supreme audit institutions often coordinate their activities, their relationship is far from clear.

There should be more clarity in the relationship between Supreme Audit Institutions and internal auditors who work in the public sector, according to a joint study by the ECIIA and the European Organisation of Supreme Audit Institutions (EUROSAI).

While internal auditors cooperate with their supreme audit institutions in most European jurisdictions on such issues as evaluating the internal control framework and risk management systems of the audited body – the internal auditors are also part of the same body that is being audited, which raises potential conflicts of interest issues.

The study, *Coordination and cooperation between supreme audit institutions and internal auditors in the public sector*, says that only a minority of jurisdictions have explicit rules, or legislation, in place that specifically deal with issues of confidentiality.

“The relationship between public sector internal auditors and supreme audit institutions is something of a ‘terra incognita,’” ECIIA President Thijs Smit says. “There is an obvious need to map more systematically and in more detail what happens in practice at the moment so jurisdictions can learn from each other what works best and improve the way that the two types of auditor cooperate.”

Despite the potential conflicts of interest that may arise, the study identified significant benefits to effective coordination including:

- Better internal and external audit activity resulting from coordinated planning and communication
- Refined audit scope for supreme audit institutions and internal auditors.

At present, audit committees seldom play a role in ensuring effective cooperation even though audit committees can act as a catalyst for better practice in this area.

“ECIIA believes that audit committees are a vital component of good corporate governance practice and have a major part to play in ensuring that benefits from coordination and cooperation are fully achieved,” Smit says.

Download the study here.

Internal audit and whistleblowing

Whistleblowers most commonly raise concerns over regulatory, health and safety breaches, internal fraud and corruption, according to a survey of chief audit executives (CAEs) by the Chartered Institute of Internal auditors – UK and Ireland.

The majority of CAEs responding to the survey, which was conducted by the Institute in support of Public Concern at Work (PCaW), said their organisations had arrangements in place to manage such risks.

But almost one-third of respondents were sceptical about the effectiveness of their whistleblowing arrangements.

The Institute has published a policy report on the role of internal audit in whistleblowing: *Whistleblowing and corporate governance: The role of internal audit in whistleblowing.*

Internal audit is well placed to be at the centre of whistleblowing systems, it says. It can provide an independent channel for the whistleblower and thereby afford the level of discretion and anonymity required. In playing this role, internal audit benefits from a greater understanding of the strengths and weaknesses of the control framework.

But if internal audit is playing this role, it cannot at the same time provide assurance to the board on the whistleblowing system, it says. So if the board needs independent assurance on the effectiveness of their whistleblowing arrangements, other sources of that assurance may be required.

Download the report here.
“No thanks” to more reform

MEP Ashley Fox wants a moratorium on corporate governance reform until the recent slew of new rules and regulations have bedded in. Arthur Piper reports

Following the financial crisis that hit Europe in 2008, the European Union has been on something of a mission to alter the behaviour of businesses operating in the zone. Its 2011 Green Paper on corporate governance and company law set out the broad basis of its approach and now the details of those reforms are passing through the European Parliament.

Recently, for example, the European Commission’s Company law and corporate governance action plan – published in December 2012 – outlined its programme to increase transparency in company reporting, help shareholders engage more effectively with business and codify existing company law directives. Other initiatives include introducing mandatory quotas for female non-executive directors on the boards of European businesses – a measure approved by the European Parliament in November last year – and reforming the region’s audit market.

While few doubt that the European Union needed to reassess the effectiveness of its corporate governance regime in the aftermath of the financial sector’s sub-prime mortgage crisis, some fear that the current welter of reform goes too far. »
Ashley Fox, Conservative MEP for the South West of England and Gibraltar, worries that an ever-increasing burden of rules and regulations on business could depress growth in the region.

“Companies provide the profit and the employment that drive prosperity,” he says, “and we are in danger in the European Union of over-regulating our businesses.”

Openness and accountability

Fox, who is on the centre-right of the political spectrum and a member of the European Conservatives and Reformists, wants to see more openness and accountability in Europe and a less prescriptive approach taken to the reform of its corporate governance regime.

For him, that means fully embracing the “comply or explain” approach first set out in the UK by Adrian Cadbury in 1992 (the Cadbury Code), under which businesses are free to follow a set of guiding principles in conducting their operations, or explain in their annual report and accounts why they have not done so. The doctrine was a central feature of his 2010 report to the Committee on Economic and Monetary Affairs when he served as Rapporteur on corporate governance in financial institutions.

Not surprisingly, he welcomes the European Commission’s adoption of “comply or explain” in its recent Action Plan, but believes that while it has embraced the language of principles, it has failed to enact its spirit in too many areas. That can be seen in the sheer volume and detail of new regulations that the European Parliament has been willing to pass.

“A lot of people in the European Parliament just don’t like capitalism,” he says. “They think that governments should control an ever-larger portion of the economy and I think that’s wrong. It diminishes our prosperity and well-being.”

Cadbury

The elements of Fox’s own brand of corporate governance are relatively straight-forward and generally follow the UK model set out in Cadbury. Companies report to shareholders using the “comply or explain” doctrine. The shareholders have a responsibility to hold those businesses to account. Within the business, a strong board of non-executive directors with diverse and appropriate skills challenge the executive and prevent any future Fred Goodwin’s – the disgraced chief of RBS – from destroying the value of the company. The regulators are there to make sure things do not get out of hand and, because the business is not overburdened with rules designed by bureaucrats, it is free to maximise its profits and create wealth.

Given that the UK was badly hit by the crisis, why does Fox still believe that a principles-based system is any better than, say, the notoriously prescriptive Sarbanes-Oxley Act regime that was rushed through in the US following the collapse of Enron? 

“Companies provide the profit and the employment that drive prosperity and we are in danger in the European Union of over-regulating our businesses”
Fox focuses on the precise mechanisms within the corporate governance regime that failed. He says that risk management in many financial institutions was poor prior to 2007 and they did not understand the complexity of the instruments on their books. In addition, some non-executive directors, and shareholders, failed to hold executive management to account and the regulators neglected to enforce the powers they already had. These views are common in the European Commission, but where Fox differs is that he believes that since these problems existed in specific parts of the financial system, any fix is best directed at them alone and not necessarily through more regulation.

"A lot of people in the European Parliament just don’t like capitalism"
– an arrangement that proved largely ineffectual. While the problems at the Co-op cannot be laid solely at the feet of Rev. Flowers, better supervisory oversight might have helped.

**Apply the rules**

“It’s sometimes not so much that we need new rules, but we need people to apply the rules that already exist,” he says. “That is a problem with the European Parliament – we always think the answer to every problem is more European-level legislation, whereas in fact we need better enforcement, or the enforcement in the first place of the existing rules. If all you do is to pass new rules, which you then don’t enforce, you have achieved nothing – or made matters worse because you give a false sense of security.”

Extending the reach of the European Parliament in the structure and running of businesses is anathema to him. That is why he is against the recently approved legislation that sets an objective for companies to have boards comprising 40% women. He supports increasing the number of women on boards, but believes that imposing quotas could lead to tokenism.

“The very last thing we want is to impose a quota that results in people who aren’t sufficiently well-qualified being appointed to fill that quota,” he says. “I think it is better to do this more gradually over a period of time and to get the right people, whether they are men or women, into the right job.”

Fox’s philosophy on corporate governance is probably best understood as letting companies get on with their central mission of wealth creation as freely as possible, at the same time as making sure that the proper checks and balances are in place and enforced to help manage the risk of doing business. So, what single thing does he think would improve the way corporate governance works across Europe?

“No more of it actually,” he says. “I’m fed up with the hyper-activity of the Commission in always wanting to regulate this, that and the other, so I would give the current reforms a chance to work.”
May last year, the Global Reporting Initiative (GRI), a worldwide body that produces guidance on non-financial reporting, launched its fourth generation of Sustainability Reporting Guidelines (G4) at the Global Conference on Sustainability and Reporting in Amsterdam. Building on twelve years of development, the new guidance calls for organisations to raise their game further than ever.

While some will see the revision of the previous GRI guidelines (G3.1) as just more red tape, the fact is sustainability reporting is now widely accepted as a conceptual and practical tool of fundamental importance in assessing an organisation’s ability to grow and create value. Its role alongside more traditional financial reporting is now well established whatever its detractors may think.

The new guidelines represent something of a revolution. That is because G4 can be seen as nothing less than a thorough-going re-specification of the sustainable approach to business. Under G4, sustainability reporting no longer aims just to measure the organisation’s impact on the outside world in retrospect, but seeks to develop a full set of tools to detect and interpret that impact in time for the business to take action. This will not only affect the organisation’s approach
to sustainability reporting, but
it will mean that internal auditors
could play a more central role in
providing assurance on the validity
of the processes that organisations
use to collate the relevant data.

Materiality
To appreciate the scope of the
new reporting system, it is
important to understand the role
that “materiality” plays in the
new guidelines. Until now that
concept applied mostly in financial
reporting, where “material”
information is that which is liable
to influence investors’ decisions.
In the new G4, it is applied to
sustainability reporting as well.

GRI defines “materiality”
as major social and economic
issues – those that reflect the
organisation’s significant
economic, environmental and
social effects on the organisation
itself and/or on society, as well
as those having an influence on
the assessments and decisions
of stakeholders. So “material”
topics will be those that have a
direct or indirect impact on the
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.

Under G4, organisations are
expected to be more active and
responsible. Rather than having
only to measure a small list of
mandatory parameters, as was the
case under the previous rules, the
process is different now, and more
complex. The organisation must
first identify and characterise the
social and environmental issues
that are material to it. In addition,
it has to share and discuss these
issues with its main stakeholders
to understand what is material to
them. The matrix that results from
this process will form the basis of
which parameters to measure.

Sustainability reporting has
therefore moved from a box-
ticking exercise, towards proper
sustainability management in which
both the organisation and its stakeholders play
a proactive part.

Risks
Naturally this minor revolution
is not without its risks. For one
thing, although organisations
have generally put non-financial
reporting processes in place, it
does not mean they are ready to
manage the issues identified as
material. Some might just keep
on reporting without ever making
the jump to actual sustainability
management. Another risk is
that sustainability targets could
continue to be scattered across
the firm in a fragmented way so
that material issues of strategic
importance are not identified.

G4 consists of two documents.
The Reporting principles and
general standard disclosures
focuses on basic principles and is
designed to provide a framework,
planning guide and summary
information for organisations
using the guidelines. The
Implementation manual contains
procedures and guidance on
material for each industry.

The new G4 has none of the
“application levels” that were
typical of G3 and G3.1. Instead,
it offers a new “in accordance”
scheme. G3’s three application
levels (A, B and C) were assigned
to Sustainability Reports on the
basis of the number of indicators
the reporting organisation could
manage to report on. The GRI
set the level but did not provide
assurance on these. It simply
limited itself to checking that the
organisation had made disclosure
on the indicators required for
that particular application level
to be assigned. The levels were
therefore a sign of the quality of
the report, not the maturity of
the undertaking’s sustainability.

Those external measures
have gone. Under G4, individual
organisations are free to decide
which topics are most material
to them and, accordingly,
which indicators to use. The
old system of “automatic”
levels is no longer relevant.

The new arrangement
consists of two options: “Core”
and “Comprehensive”. The Core
option comprises part of the
standard disclosures and at least
one indicator for each aspect
identified as “material” for that
undertaking. The Comprehensive
option comprises all disclosures
and all relevant indicators. The
Comprehensive option will be
chosen by organisations claiming
to be leaders on sustainability
issues and capable of reporting
on all the indicators material
to them. The Core option, on
the other hand, is designed for
organisations that are not yet in a
position to give an account of

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moved from a box-ticking exercise,
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all indicators, though even they are still required to show their timetable for the introduction of comprehensive reporting.

**Assurance**

For G4, as for earlier versions, the GRI recommends but does not mandate a process of external assurance. In fact, the lines that such a process should follow have not yet been clearly established because the responsibility of the auditor shifts from the verification of purely quantitative data after the fact to providing assurance on the management and disclosure processes that the organisation has followed with regard to the issue of materiality. The GRI and the audit companies are still working on that topic.

G4 also has some pointers for internal auditors. The reference to internal assurance in the *Implementation manual* emphasises the role and importance of the internal control system. Organisations can establish an internal audit function as an integral part of their processes for risk management and for managing and reporting all the information they generate.

Internal audit must play a major part within the internal control system to ensure that the financial and the social and environmental aspects function properly. This is a step towards a still greater role for internal audit within the organisation. While the abilities and experience of internal auditors are already acknowledged when it comes to profit and loss, assets, liabilities and finance, in future they shall be called on to make a contribution and provide support for issuing assurances on social and environmental aspects as well. Internal auditors will need to be better equipped to pronounce on these areas.

In addition, internal audit could be called on to provide overall assurance on all material processes: how they are identified, structured and implemented. Global IIA has identified sustainability as a major strategic topic, and the GRI and IIA are in discussion to find a formula for a worldwide partnership in which, on the one hand, the GRI can help the IIA and the internal auditing profession to strengthen its understanding of the issues of sustainability and sustainability reporting, while, on the other hand, providing GRI a hand in unifying the parameters needed to specify all the assurance topics which still remain open.

While some details of the GRI’s new approach have clearly to be finalised, the impact on the way that organisations report on sustainability is likely to be wide-ranging. If successful, it will provide them with a more timely and relevant reporting mechanism to manage their economic, social and environmental responsibilities.

Silvio Girolamo is on the Management Board of ECIIA and is a Stakeholder Council Member of the Global Reporting Initiative. Click here for GRI’s G4 Sustainability reporting guidelines.

“Internal audit must play a major part within the internal control system to ensure that the financial and the social and environmental aspects function properly”
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