Empowerment and challenges for the Internal Audit Function

The new Dutch Corporate Governance Code

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ne year ago, in December 2016, the Dutch Corporate Governance Code Monitoring Committee, chaired by Prof. dr. Jaap van Manen, published the revised Dutch Corporate Governance Code. This Code has been revised at the request of several Dutch institutions. Amongst them the trade unions CNV and FNV, representative of institutional investors Eumedion, stock exchange organization Euronext, association of stockholders VEB, association of securities-issuing companies VEUO and the representative for Dutch industries and employers VNO-NCW.

From a broad perspective, in the ‘look and feel’, the most important changes in the new Code are the central role of long-term value creation and the company culture as important components of effective corporate governance. The revised Code is not only a next step for good corporate governance, but is also changing the relevance and role of the Internal Audit Function (IAF).

History of the Code

The Dutch Corporate Governance Code (‘the Code’) was introduced in 2003 by the Committee, chaired by former Unilever CEO Morris Tabaksblat. The Code, formerly also known as ‘the Tabaksblat Code’, focused on the governance of listed companies. The Code contains both principles and best practice provisions for the relation between the management board, the supervisory board and the shareholders of the listed company. The principles achieved broad acceptance and helped develop attitudes and minimum standards for good corporate governance.

Compliance with the Code is in accordance with the ‘apply or explain’ principle. Companies should in essence apply the principles and best practice provisions of the Code, however companies may deviate from these. In such case, they are expected to provide sound explanation for any non-compliance or non-application of a provision. According to Dutch law information on compliance with the Code should form part of the annual report of the company. This gives current and future shareholders the opportunity to have insight into the company’s functioning and actions.

The original Code was adopted in 2003 by the Tabaksblat Committee, and later, in December 2008, amended by the Frijns Committee. In 2016 the Code was revised by the Van Manen Committee. According to Dutch law listed companies are required to report on compliance with the revised Code as of the 2017 financial year.

The Van Manen Committee found several reasons to make necessary revisions to the Code. An important reason was that even though most listed companies had complied with the Code, since the start of the original Code in 2003 there had been many adverse incidents in these companies, such as financial fraud and bankruptcies. The chairman Van Manen stated his view that many of these incidents were based on the pursuit of short-term profits resulting in long-term problems and weak business models. Additionally, the Van Manen Committee concluded that the Code had become more a topic for legal experts instead of for boards and shareholders. That was also the reason that the Van Manen Committee held a broad consultation with existing and new stakeholders; not only with the original advising partners, but for instance with all involved listed companies.

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and several professional organizations such as the institutes for chartered accountants and internal auditors. The goal was to gain broad insight into existing problems, challenges and possible solutions and best practices.

The revised Code and the Internal Audit Function
Since the start of the Code in 2003, the Internal Audit Function has a role in the Code. In the original Code principle V.3 stated: «The internal accountant has an important role in assessing the companies’ risk and control system.» The corresponding best practice was that the external (statutory) auditor and the Audit Committee are involved in both the planning and the outcomes of the internal audits. In that period, the Code’s focus for the Internal Audit Function was more on financial reporting and control.

In the revised 2008-Code, the Internal Audit Function was more empowered due to the latest best practices and it was stated that:

- The Internal Audit Function has direct access to the chairman of the Audit Committee and the external (statutory) auditor; and
- If the company does not have an Internal Audit Function, the Audit Committee is required to evaluate annually whether there is still no necessity to have an Internal Audit Function. This evaluation should be part of the Supervisory Board’s report to shareholders (annual report).

However changes were made to the Code, Internal Audit did not have the formal role and importance it would become with the revised 2016-Code. The focus was still more on financial reporting risks and absence of an Internal Audit Function within a company could still be substantiated with economic reasons, such as the limited size of the company.

In the revised 2016-Code, Internal Audit Function’s role has been revised as well. Instead of a more reactive and more financial reporting and control oriented internal audit function, it has shifted into a more active and a strategy and operations oriented assurance and consulting function. As stated in principle 1.3 (Internal Audit Function) of the revised Code: «The duty of the internal audit function is to assess the design and the operation of the internal risk management and control systems. The management board is responsible for the internal audit function. The supervisory board oversees the internal audit function and maintains regular contact with the person fulfilling this function.»

Within this principle, several important statements are made:
- Companies are expected to have an internal risk management and control system;
- These systems need to be assessed;
- Internal audit has the role of assessing these risk management and control systems;
- Internal audit is in direct contact with both the management board and the supervisory board.

Regarding the risk management and control system, the revised Code follows the Committee’s focus on long-term value creation and the company culture as important components of effective corporate governance. These elements are also addressed in the principles regarding risk management:

- **Principle 1.2 Risk Management:** «The company should have adequate internal risk management and control systems in place. The management board is responsible for identifying and managing the risks associated with the company’s strategy and activities.»

- **Principle 1.2.1 Risk Assessment:** «The management board should identify and analyse the risks associated with the strategy and activities of the company and its affiliated enterprise. It is responsible for establishing the risk appetite, and also the measures that are put in place in order to counter the risks being taken.»

- **Principle 1.2.2 Implementation:** «Based on the risk assessment, the management board should design, implement and maintain adequate internal risk management and control systems. To the extent relevant, these systems should be integrated into the work processes within the company and its affiliated enterprises, and should be familiar to those whose work they are relevant to.»

- **Principle 1.2.3 Monitoring of effectiveness:** «The management board should monitor the operation of the internal risk management and control systems and should carry out a systematic assessment of their design and effectiveness at least once a year. This monitoring should cover all material control measures relating to strategic, operational, compliance and reporting risks. Attention should be given to observed weaknesses, instances of misconduct and irregularities, indications from whistleblowers, lessons learned and findings from the internal audit function and the external auditor. Where necessary, improvements should be made to internal risk management and control systems.»

As mentioned before, the Internal Audit Function has an important and mandatory role in the risk management process of the company. Regarding the functioning of the Internal Audit Function, the Code also includes the following principles:

- **Principle 1.3.1 Appointment and dismissal:** «The management board both appoints and dismisses the senior internal auditor. Both the appointment and the dismissal of the senior internal auditor should be submitted to the supervisory board for approval, along with the recommendation issued by the audit committee.»

- **Principles 1.3.2 Assessment of the internal audit function:** «The management board should assess the way in which the internal audit function fulfils its responsibility annually, taking into account the audit committee’s opinion.»

- **Principle 1.3.3 Internal audit plan:** «The internal audit function should draw up an audit plan, involving the management board, the audit committee and the external auditor in this process. The audit plan should be submitted to the management board, and then to the supervisory board, for approval. In this internal audit plan, attention should be paid to the interaction with the external auditor.»

- **Principle 1.3.4 Performance of work:** «The internal audit function should have sufficient resources to execute the internal audit plan and have access to information that is important for the performance of its work. The internal audit function should have direct access to the
audit committee and the external auditor. Records should be kept of how the audit committee is informed by the internal audit function.»

- **Principle 1.3.5 Reports of findings**:
  «The internal audit function should report its audit results to the management board and the essence of its audit results to the audit committee and should inform the external auditor. The research findings of the internal audit function should, at least, include the following:
  
  • i. any flaws in the effectiveness of the internal risk management and control systems;
  • ii. any findings and observations with a material impact on the risk profile of the company and its affiliated enterprise; and
  • iii. any failings in the follow-up of recommendations made by the internal audit function.»

- **Principle 1.3.6 Absence of an internal audit department**:
  «If there is no separate department for the internal audit function, the supervisory board will assess annually whether adequate alternative measures have been taken, partly on the basis of a recommendation issued by the audit committee, and will consider whether it is necessary to establish an internal audit department. The supervisory board should include the conclusions, along with any resulting recommendations and alternative measures, in the report of the supervisory board.»

The Internal Audit Function: empowerment and challenges

The revised Code includes both empowerment and challenges for the Internal Audit Function. On the one side, due to the formal inclusion of Internal Audit’s role in the Code, companies need to comply with the principles. As Committee chairman Van Manen stated: «If with the revised Code companies do not have a well-functioning Internal Audit Function, they really have something to explain to their shareholders». Empowerment is not only because of the inclusion of Internal Audit in the Code, but more because of:

- Internal Audit’s link with both the management board and the supervisory board;
- Internal Audit’s interaction with the external auditor, in which each party has its own special role.

These empowerment factors are not only helping, but also challenging the Internal Audit Function. The function must be well-staffed, innovative, communicative and able to meet the companies’ needs and long-term requirements to provide both assurance and advice to the Board regarding the long-term value creation and strengthening of the company culture. Instead of focusing on short term financial control, Internal Audit should focus on the company’s strategic risks, risk appetite and corresponding level of control in line with company’s risk appetite. It must focus also on the culture of the company, for instance in the use of soft controls.

These changes will challenge not only the company, but also the Internal Audit Function and its auditors. This is also what the message is conveyed by the Dutch IIA chapter (IIA Netherlands). Many years ago, IIA Netherlands’s Board started an ‘Advocacy’ process in which IIA started to actively inform relevant stakeholders about the role of the Internal Audit Function and current best practices and developments. IIA Board members had meetings with stakeholders such as the Dutch Corporate Governance Code Monitoring Committee, management and supervisory board members of listed companies and representatives of relevant Dutch institutions, such as the advising parties to the Monitoring Committee. In these meetings stakeholders not only affirmed the past achievements of the Internal Audit Function, but also emphasized the necessity for a continuous improvement.

In the end it resulted in the inclusion of the Internal Audit Function in the revised Code, as described above. As Committee Chairman Jaap van Manen stated: «Our Committee spoke to many representatives of many organizations, amongst them also IIA Nederland. Many representatives emphasized the great importance of their organization and profession. But I have a simple rule: I believe an organization or profession is really that important if not they themselves, but relevant stakeholders, like supervisory board members, say they are important. That’s why the Internal Audit Function has the formal role as described in the revised Code». On the other hand, Van Manen had a warning too: «The Internal Auditors managed to convince relevant stakeholders of the importance and quality they have and the added value they can bring into the strategic development of the companies they work for. But ‘noblesse oblige’: you will have to meet continuously the expectations you made and provide the expected added value.»

The conclusion is that the revised Code empowers the Internal Audit Function and allows it to make a big next step towards adding more value to companies, their boards and stakeholders. But internal auditors cannot sit and wait, they meet new challenges. They and their professional organization, the IIA, need to be constantly taking further steps in meeting the expectations and challenges by continuously strengthening the knowledge and skills of internal auditors.

You can find the Dutch Corporate Governance Code and other documents (partly in English) on the website of the Monitoring Committee (www.mccg.nl) and IIA Netherlands (www.iaa.nl).

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