Federation of European Accountants
Fédération des Experts comptables Européens

Auditing and Assurance

Company Law and Corporate Governance

Discussion Paper for Auditor's Role Regarding Providing Assurance on Corporate Governance Statements

November 2009

Standing for trust and integrity

Federation of European Accountants
Fédération des Experts comptables Européens

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Company Law and Corporate Governance Subgroup on Assurance on Corporate Governance Statements

About FEE

FEE (Fédération des Experts comptables Européens – Federation of European Accountants) represents 43 professional institutes of accountants and auditors from 32 European countries, including all of the 27 EU Member States.

In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent, and sustainable European economy.

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1. EXECUTIVE SUMMARY

1.1. Background

In recent years, many countries have introduced mandatory requirements and voluntary codes of corporate governance. In some countries developments have been limited to implementation of the most recent requirements of European law which require listed companies to disclose certain information around their governance practices and to have an audit committee. In other countries governance requirements have gone considerably further, often based on, or exceeding, the principles of the OECD Principles of Corporate Governance.

Sound corporate governance is particularly important in financial reporting as it is a key factor in ensuring confidence in capital markets through the provision of financial and other information of the highest quality.

Good corporate governance highlights the importance of non-executive directors, the audit committee function and their structures and relationships with the board(s). It also focuses on internal controls, internal audit, external audit and disclosures about corporate governance. In particular, it considers the fundamental relationships and obligations between boards, auditors and shareholders. The external auditor can add value by reporting on his independent assessment of whether certain aspects of the corporate governance statement comply with defined reporting standards.

Such measures will undoubtedly strengthen the corporate governance practices within individual companies. The disclosures of these practices is certainly a key element as it allows investors, stakeholders and others to form their own view as to the way a company is governed. Again, some countries have implemented the requirements of European law, and others have gone further.

The final step in this process is the involvement by an independent and suitably qualified practitioner, whether the statutory auditor or another practitioner, to perform work on these governance disclosures. European law lays down certain things that the statutory auditor must do; some countries have required auditors to do more, and in other countries the auditor or others are engaged voluntarily by a company to do more work.

1.2. FEE's project on the auditor's role regarding providing assurance on corporate governance statements

The scope of the project is:

- To outline the key elements of corporate governance codes and practices in Europe, together with key legal and regulatory requirements;
- To summarise the main features of corporate governance reporting by European companies under existing practice and the recent changes to the Fourth and Seventh Directives;

- To explain the different levels of potential auditor involvement with different types of corporate governance disclosures, together with the required involvement with the disclosures required by EU law;

- To explain FEE's views as to the potential maximum involvement of the auditor with different types of corporate governance disclosures; and

- To provide some examples of how auditors might report on their involvement.

Unless otherwise stated, the term 'auditor' is used in this Discussion Paper to mean any independent and suitably qualified practitioner and not necessarily solely the statutory auditor appointed to audit the financial statements.

1.3. Key conclusions

Elements of corporate governance and corporate governance statements

During the period from 2007-2008, FEE carried out a survey of their Member Bodies asking questions about corporate governance in their countries. Responses to these questions indicated that, despite the range of legal systems, institutional frameworks and traditions, there is considerable convergence across Europe in the elements of national corporate governance codes. Most of these codes are closely related to the OECD's Principles of Corporate Governance – either by making explicit reference, or by incorporating the principles within the national code, supplemented by local rules and guidance.

Countries have also implemented key requirements of European law including:

- The requirements of the amended Fourth and Seventh directives which require disclosures of certain corporate governance practices in a mandatory corporate governance statement to be produced by each listed company;

- The requirements of the Statutory Audit Directive for public interest companies to have an audit committee;

- The requirements of the Shareholder Rights Directive which, unsurprisingly, deals with the exercise of rights by shareholders.

These three pieces of legislation interact – the audit committee has a role to play in monitoring and oversight of certain governance practices; the company then has to disclose these practices; this provides shareholders with information on governance which will inform the decisions they take when exercising their rights.

Additional disclosures, over and above the minimum requirements of European law as stipulated above, are common. Typically these might include information on remuneration, more detail on the operation of the board and its committees, and further detail on risk management and internal control.

Auditor involvement in corporate governance statements

The involvement of a suitably qualified independent auditor (whether the auditor appointed to audit the company's financial statements or another independent and suitably qualified practitioner) can increase the degree of confidence of users of corporate governance information. There is a range of practice across Europe:

- The EU directives require certain matters to be considered including the consistency of certain corporate governance information with the financial statements and whether certain other corporate governance information has been produced or included in a statement;

- Some countries have gone further and require mandatory reporting by the statutory auditor regarding other governance practices. This reporting is sometimes of factual findings, and sometimes is an assurance engagement. An assurance engagement requires the expression of an opinion by a practitioner about the outcome of the evaluation or measurement of a subject matter against suitable criteria. An assurance engagement may be a reasonable assurance engagement, resulting in a positive form of conclusion (i.e. "In our opinion… is so.") or a limited assurance engagement resulting in a negative form of conclusion (i.e. "Based on our work, we are not aware of anything that suggests that … is not so.").

FEE also considered the potential for increased involvement by auditors with corporate governance information, considering the range of subject matters which our survey of governance reporting identified as being common across Europe. We concluded that there was not one "right answer" as to the desirable level of involvement by an auditor. Some information may be suitable only for factual verification because it is subjective in nature – auditors can check underlying facts regarding remuneration of directors but will not be able to form an opinion as to whether a company's remuneration policy will lead to the directors achieving the company's stated strategy. Other information may be the subject of an assurance engagement, but the level of cost and benefit varies significantly. For example, providing assurance regarding a description of internal control may be relatively low cost, whereas forming an opinion as to its effectiveness is significantly higher. Table 3 in Chapter 6 includes FEE's view as to the potential maximum level of auditor involvement in key areas of corporate governance.

FEE has also developed some examples of what corporate governance reporting by auditors might look like. These are set out in Chapter 7.

1.4. Invitation to comment

FEE would be interested to receive comments on any of the issues discussed in this document.

Please send comments to the FEE Secretariat by e-mail to hilde.blomme@fee.be or post to:

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2. INTRODUCTION

2.1. Background

A number of years ago, several major financial reporting scandals (e.g. Enron, Worldcom) have led to growing interest in corporate governance which "*is the system by which companies are directed and controlled*" [1] at the highest level of the organisation. The 2007 sub-prime crisis, the resultant financial turmoil and the recent global economic recession have furthered the focus on several aspects of corporate governance. Shareholders and other stakeholders are currently focussing on issues such as the levels and basis of management remuneration including bonuses and the role of the audit committee, thus seeking more relevant disclosures in this respect.

2.2. Recent European legislation

In order to enhance investors' confidence in the financial statements and annual reports published by European companies, the European Commission set up the High Level Group of Company Law Experts ("the Winter Group"). The group was set up in July 2001 and on 4 November 2002, the Winter Group presented its final report on *"A modern regulatory framework for company law in Europe"* (referred to hereafter as "the Winter Group Report")[2].

On 21 May 2003, the European Commission published a Communication on the Company Law Action Plan "Modernising Company Law and Enhancing Corporate Governance in the EU"[3] (referred to in this document as the Commission's Communication on Company Law and Corporate Governance), to implement the Winter Group Report which dealt with the introduction of a corporate governance statement for all European Union (EU) listed companies. The objective of the European Commission was to modernise the European regulatory framework for company law and corporate governance.

For that purpose, on 14 June 2006 the European Parliament and the Council amended the Fourth and Seventh Directives[4]. Accordingly, each listed company should, in principle in a specific section of its annual report (management report)[5] – disclose information about its practices in a "corporate governance statement".

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1 Paragraph 2.7 of the Cadbury Report, p. 14.
2 http://ec.europa.eu/internal_market/company/modern/index_en.htm
3 http://ec.europa.eu/internal_market/company/modern/index_en.htm
4 Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, *O.J.E.U.*, 16 August 2006, L 224, p. 7.
5 As defined in section 4.5 below.

The corporate governance statement shall contain:

a) A reference to the applicable corporate governance code and/or the corporate governance code which the company has voluntarily decided to apply and/or all relevant information about the corporate governance practices applied beyond the requirements under national law;

b) To the extent a company departs from a corporate governance code, an explanation as to which parts of the code it departs from and the reasons for doing so. This relates not only to specific provisions but to the code as a whole;

c) A description of the main features of the company's internal control and risk management systems in relation to the financial reporting process.

In addition the statement shall contain information on take-over bids, on the composition and operation of the various boards and on the operation of the shareholders meeting.

The consolidated annual report shall also contain a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts. If the consolidated annual report and the annual report are presented as a single report, this information must be included in the section of the report containing the corporate governance statement.

The Fourth and Seventh Directives further impose on members of the board the collective duty to draw up and publish a corporate governance statement. It states that there should be penalties for infringing the implementation of the national provisions.

The meaning of the "board" may differ depending on the two main types of board structures: the unitary board system or the two-tier board system with a management board[6] and a supervisory board[7] that may have different responsibilities.

A unitary board is comprised of executive and non-executive directors. In a two-tier system the term "board" distinguishes between the management board, whose members have executive responsibilities, and the supervisory board, responsible for the monitoring and supervision of the company's management. Variations exist within the two-tier system, and the responsibilities of the supervisory board could in some countries include responsibilities for the strategic direction of the company (and assume certain management decisions).

EU Member States may permit the information required to be included in a corporate governance statement, to be set out in a separate report published together with the annual report, or disclosed by means of a reference in the annual report to where such document is publicly available on the company's website.

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6 'Management body' means one or more individual managing directors, the management board (dual board) or the administrative board (unitary board) (extract from the proposal of the European Council regulation on the statute for a European private company).

7 'Supervisory body' means the supervisory board (dual board), designated as being responsible for the supervision of the management body (extract from the proposal of the European Council regulation on the statute for a European private company).

The Fourth Directive also provides a specific role for the statutory auditor depending on whether the corporate governance statement is included in the annual report or is published separately.

2.3. Objective

In previous position papers[8], FEE has discussed the audit implications of inclusion of the corporate governance statement in the annual report (management report). However, FEE did not, until now, consider what form and level of involvement, if any, the auditor could have and could not have with (the various elements of) the corporate governance statement.

This FEE Discussion Paper considers the role of the auditor in the area of corporate governance statements and hopes to stimulate debate. It may provide input to the IAASB and others as to the ways in which existing standards can be applied to the auditor's involvement with aspects of corporate governance reporting and as to the demand for, and possible form of, future standards or guidance in this area. Confidence in financial reporting, and in assurance, is a key factor in ensuring confidence in capital markets. The Discussion Paper is expected to be of interest to all parties involved in the corporate governance debate including regulators, the accountancy profession, executive and non-executive directors, shareholders and other stakeholders. There may be differences in needs between EU Member States as institutional shareholders are more active in some countries than in others.

2.4. Scope

The scope of the project is:

- To outline the key elements of corporate governance codes and practices in Europe, together with key legal and regulatory requirements;
- To summarise the main features of corporate governance reporting by European companies under existing practice and the recent changes to the Fourth and Seventh Directives;
- To explain the different levels of potential auditor involvement with different types of corporate governance disclosures, together with the required involvement with the disclosures required by EU law;
- To explain FEE's views as to the potential maximum involvement of the auditor with different types of corporate governance disclosures; and
- To provide some examples of how auditors might report on their involvement.

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[8] Including the *FEE Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance* (July 2003).

Unless otherwise stated, the term 'auditor' is used in this Discussion Paper to mean any independent and suitably qualified practitioner, which will include but not be limited to the "statutory auditor". Unless otherwise stated, the term "statutory auditor" is used in this Discussion Paper to mean the independent external auditor (or in the case of a joint audit, auditors) appointed to audit the company's or entity's financial statements.

This Discussion Paper should be read in conjunction with other FEE papers such as the *FEE Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance* (July 2003)[9], the *FEE Discussion Paper on Risk Management and Internal Control in the EU* (March 2005)[10] and the *FEE Comment Paper on Analysis of Responses to FEE Discussion Paper on Risk Management and Internal Control in the EU* (May 2006)[11]. Where appropriate and relevant, this Discussion Paper makes reference to those papers.

It should be noted that this Discussion Paper only deals with the publicly available corporate governance statements. Additional corporate governance related information may be available which is not publicly disclosed. Such information, including any possible auditor involvement therewith, is outside the scope of this Discussion Paper, including any possible auditor involvement therewith.

This project is not intended to override the conclusions of other FEE projects such as those on sustainability assurance and on risk management and internal control, but to add to them by considering the provision of assurance on other elements in the corporate governance statement.

2.5. Survey

FEE surveyed its Member Bodies during the period from 2007 to 2008 to provide an insight into corporate governance reporting practices and levels of auditor involvement. FEE has received responses from 26 EU Member States, as well as from Norway and Switzerland. The main findings of the survey are set out in Chapter 4 (elements included in corporate governance statements) and 5 (the involvement of the auditor with corporate governance statements).

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[9] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=264

[10] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=351

[11] http://www.fee.be/publications/default.asp?library_ref=4&content_ref=564

3. Elements of Corporate Governance

3.1. Introduction

This Discussion Paper focuses on corporate governance disclosures and the extent to which auditors may be involved with them. Before discussing the types of disclosure that may be reported, this chapter sets out common elements of corporate governance codes and laws across Europe.

3.2. Principles of Corporate Governance Codes

Many corporate governance codes have emerged since the 1990s. A recognised set of principles used as an international benchmark for policy makers, investors, corporations and other stakeholders worldwide are the Principles published by the Organisation for Economic Cooperation and Developments (OECD[12]). At the European level, the European Commission (EC) co-ordinates EU Member States' efforts to improve corporate governance practices, through the establishment in 2004 of the European Corporate Governance Forum ("ECGF") which examines best practices in EU Member States with a view to facilitate convergence of national corporate governance codes and to provide strategic advice to the EC.

The ECGF did not recommend the development of a single European corporate governance code. FEE supports this position which is consistent with both the Winter Report and the EC Communication on Company Law and Corporate Governance of November 2008. However, it is clear that those developing corporate governance codes in each country have had regard to codes in some other countries and the OECD Principles. This, coupled with the fact that investors, the key users of corporate governance statements, operate across European borders, means that there is a fairly high degree of commonality of reporting in many countries, as identified by FEE's survey in Section 3.3 below.

3.3. Main Results of the FEE Survey on Corporate Governance Codes

During the period from 2007-2008, FEE carried out a survey of their Member Bodies asking questions about corporate governance in their countries. The objective of FEE's survey was to consider firstly, the common elements of the existing corporate governance codes to which corporate governance statements generally refer, and secondly, the form of involvement that the auditor has, if any.

The analysis of the responses to our questions regarding the content of corporate governance statements indicates that, although different legal systems, institutional frameworks and traditions led to different approaches within Europe, there is considerable convergence in the elements included in national corporate governance codes. All the countries that responded have a corporate governance code, guidance, or recommendations recognised, recommended or even mandated by law, by a regulator (whether of company law, securities or financial services) or by a stock exchange. Unsurprisingly, the OECD Principles are widely referred to in national codes

[12] *OECD Principles of Corporate Governance*, 2004, 69 p. (http://www.oecd.org/dataoecd/32/18/31557724.pdf)

– either by explicit reference or by incorporating the principles themselves or something similar.

The analysis shows that almost all corporate governance codes across Europe follow most of the principles set out by the OECD. These principles are:

1. Ensuring the Basis for an Effective Corporate Governance Framework: the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities;

2. The Rights of Shareholders and Key Ownership Functions: the corporate governance framework should protect and facilitate the exercise of shareholders' rights;

3. The Equitable Treatment of Shareholders: the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights;

4. The Role of Stakeholders in Corporate Governance: the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises;

5. Disclosure and Transparency: the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company;

6. The Responsibilities of the board: the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Based on the FEE survey, it appears that in some EU Members States, the principles included in their corporate governance codes may be different and may have a different content than illustrated below. In other EU Member States, some of these principles may be binding because they are required by law or regulation.

In this paper the term "Board" covers the Board of Directors, the Management Board, or the Supervisory Board, depending on the use of a single tier or two-tier management system, as outlined in Chapter 2.2.

Table 1 below shows principles common to most national corporate governance codes across Europe.

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Table 1 - Principles included in most corporate governance codes across Europe

#	Principles included in corporate governance codes across Europe
1	**Effective Board** Every company should be headed by an effective Board which is collectively responsible for the performance of the company. i.e. Setting strategy, values and standards, integrity of financial information, risk management.
2	**Chairman and Chief Executive: clear division of responsibilities** Clear division of responsibilities at the top of the company between chairing the Board and the executive responsibility for managing the company's operations. No one individual should have unfettered powers of decision. i.e. The Chairman should be responsible for leadership of the Board, ensuring its effectiveness on all aspects of its role and setting its agenda. He should also be responsible for ensuring that the directors receive accurate, timely and clear information. The Chairman should ensure effective communication with shareholders.
3	**Board balance and independence** The Board should include a balance of composition of directors. Commonly codes refer to a balance between executive and non-executive directors (and in particular independent non-executive directors). Some codes go further and refer to a balance of gender, qualifications, experience and background. There should be procedures to ensure that no individual or small group of individuals can dominate the Board's decision taking. i.e. Sufficient size that the balance of skills and experience is appropriate for the requirement of the business; powers and information not concentrated in one or two individuals.
4	**Procedure for appointments to the Board** There should be a formal and transparent procedure for the appointment of new directors to the Board. Proposals on the election and remuneration of the Board of Directors should be prepared in a structured, transparent process. The task of the nomination committee should be to consider proposals made by the relevant parties and should make a recommendation or provide advice for the appointment of the members of the Board.
5	**Information and professional development** - The Board should be supplied in a timely manner with information. - The information supplied to the Board should be in a form and of a quality appropriate to enable it to discharge its duties. - All directors should receive training on joining the Board and should regularly update and refresh their skills and knowledge.
6	**Performance evaluation of the Board** The Board should undertake a formal annual evaluation, e.g. of its performance and that of its committees and individual directors.
7	**Re-election of the Directors** - All directors should be submitted for re-election at regular intervals. - All directors should be subjected to continued satisfactory performance. - The Board should ensure planned and regular changes in Board's membership.

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#	Principles included in corporate governance codes across Europe
8	**Remuneration of the Directors and Board policy and level**[13] - Directors' remuneration policy: Listed companies should disclose a statement of the remuneration policy on directors of the company including the preparatory and decision making process used. - Disclosure of the remuneration of individual directors: The total remuneration and other benefits granted to individual directors should be disclosed in detail in the financial statements or in the notes or, where applicable in a separate remuneration report.
9	**Reporting** - The Board should present a balanced and understandable assessment of the company's position and prospects (year-end). The quality of the reporting should be ensured in the form of policies, instructions for responsibility distribution. - The Board's responsibility should extend to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements (interim). In addition, the Board should establish formal and transparent arrangements for assuming responsibility for the preparation of the Board's work to ensure the quality of the company's financial reporting, for considering how they could apply the financial reporting and internal control system and for maintaining an appropriate relationship with the statutory auditors.
10	**Internal Control and Risk Management systems** The Board should maintain a sound system of internal control and risk management to safeguard shareholders' investment and the company's assets. The Board should issue a statement that it is responsible for monitoring the company's internal control and risk management systems and for reviewing their effectiveness.
11	**Audit committee and Auditors** The audit committee monitors: - The financial reporting process; - The effectiveness of the company's internal control and risk management systems, the internal audit function where applicable; - The statutory audit of the annual and consolidated accounts; and - Reviews and monitors the independence of the statutory auditor or firm and particularly the provision of additional services.
12	**Other Committees** - The Board should stipulate formal procedures for the work of the Board and its committees. - These procedures should be clear and well documented. - Depending on the specifics of the enterprise and the number of its members, the Board should form committees with sufficient expertise. They should be aimed at increasing the efficiency of the Board's work and the handling of complex issues.
13	**Dialogue with shareholders and other stakeholders** There should be a dialogue with shareholders and other relevant stakeholders based on the mutual understanding of objectives. The Board as a whole should have responsibility for ensuring that a satisfactory dialogue with shareholders

[13] EC Recommendation on the remuneration of directors of listed companies of 14 December 2004 (2004/913/EC)

#	Principles included in corporate governance codes across Europe
	and other stakeholders takes place.
14	**Constructive Use of the Annual General Meeting (AGM)** The Board should use the AGM to communicate with investors and to encourage their participation.
15	**Shareholder Voting** The company should facilitate the use by shareholders of their votes.

3.4. Specific elements of corporate governance required by European law

There are certain key elements of corporate governance established by various European laws. The remainder of this chapter summarises certain key provisions of European law and EC recommendations.

3.4.1. Collective responsibility of board members for the annual accounts and reports

Directive 2006/46/EC amended the Fourth and Seventh Directives to include a requirement that Member States ensure the collective responsibility of board members towards the company for the annual accounts and reports.

3.4.2. Audit committees

Article 41 of the Statutory Audit Directive of 17 May 2006 obliges public-interest entities to have an audit committee[14] which should:

- Monitor the financial reporting process;
- Monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- Monitor the statutory audit of the annual and consolidated accounts; and
- Monitor and review the independence of the statutory auditor or firm and particularly the provision of additional services.

Currently FEE is undertaking a project on the implementation of Articles 37, 38 and 41 of the Statutory Audit Directive and the relationship between Auditor and Audit Committee. It expects to issue a discussion paper on this topic in the near future.

[14] In certain cases, the Statutory Audit Directive permits this role to be undertaken by another body e.g. the board as a whole (in a one-tier board system) or a supervisory board (in a two-tier board system).

3.4.3. Shareholder Rights

The EU Shareholder Rights Directive (2007/36/EC) came into force on 3 August 2009. This provides for certain key rights of shareholders which are, in summary:

- Sufficient advance notice of, and prior information for, general meetings;
- The abolition of "share-blocking" – the process where, on a specific date prior to a company meeting (usually a number of weeks before), shareholders are required to notify the company of their identity and intention to vote. After this date the shares involved cannot be traded;
- Removal of legal obstacles to electronic participation;
- The right of shareholders to ask questions at general meetings;
- Voting by correspondence.

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4. ELEMENTS INCLUDED IN CORPORATE GOVERNANCE STATEMENTS

Chapter 3 considered the key elements of corporate governance. This chapter moves on to consider the sorts of information relating to corporate governance that may be reported by companies, either in their annual report (management report) or elsewhere. Not all provisions of corporate governance codes are necessarily reported on, and not all of them would benefit from auditor involvement. This is because:

- Information on some aspects of corporate governance may benefit more from the association of an auditor than on others;

- The nature of certain information may be so subjective that assurance or verification is not possible;

- The type of information may affect the work effort required for verification or assurance.

Therefore, this chapter summarises the common elements of corporate governance statements, drawing on a survey of FEE Member Bodies.

It sets out the specific requirements of EU law before going on to consider other common elements of statements across Europe as identified by FEE.

4.1. General definition of a Corporate Governance Statement

The "corporate governance statement" is the published report on the Board's governance that states whether it has complied with the provisions of a corporate governance code or corporate governance practices and the reasons for any area of non-compliance.

FEE has described in its *Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance* (p. 55) the two key approaches to corporate governance reporting:

- The "descriptive" approach requiring a narrative description of the corporate governance structure implemented within the reporting company and of how the company has applied the corporate governance principles;

- The "comply or explain" approach requiring a statement whether the reporting company has observed the applicable code and an explanation of any area of non-compliance.

Publishing a corporate governance statement increases the Board's external responsibility not only towards shareholders who know where the companies in which they have invested stand in relation to the relevant corporate governance code(s), but also to the market in general. This disclosure is intended to provide sufficient information for shareholders and other third parties to assess the stewardship of management and to exercise their ownership rights on an informed basis. It is also a powerful tool for influencing the behaviour of companies, for protecting investors and to improve corporate governance. Disclosure also helps improve public understanding

of the structure and activities of companies, corporate policies and increasingly performance with respect to environmental and ethical standards, and companies' relationships with the communities in which they operate.

4.2. Elements of the Corporate Governance Statement following the 2006 Directive amending the Fourth and Seventh Directives

The 2006 Directive amending the Fourth and Seventh Directives creates, in Article 46a, the obligation for listed companies to include a corporate governance statement in their annual report. The Directive gives Member States the option to require instead that companies set out the information in a report separate from the annual report, published together with the annual report or disclosed by means of a reference in the annual report to where such a document is publicly available on the company's website. The Fourth Directive provisions describe the elements that a corporate governance statement shall contain as a minimum[15]:

"a) A reference to:

- (i) the corporate governance code to which the company is subject; and/or
- (ii) the corporate governance code which the company may have voluntarily decided to apply; and/or
- (iii) all relevant information about corporate governance practices applied beyond the requirements under national law.

Where points (i) and (ii) apply, the company shall also indicate where the relevant texts are publicly available; where point (iii) applies, the company shall make its corporate governance practices publicly available;

b) To the extent to which a company, in accordance with national law, departs from a corporate governance code referred to under points (a)(i) or (ii), an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so. Where the company has decided not to apply any provisions of a corporate governance code referred to under points (a)(i) or (ii), it shall explain its reasons for doing so;

c) A description of the main features of the company's internal control and risk management systems in relation to the financial reporting process;

d) The information required by Article 10(1), points (c), (d), (f), (h) and (i) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on take-over bids, where the company is subject to that Directive. These require disclosure of:

- Significant direct and indirect shareholdings (including indirect shareholdings through pyramid structures and cross-shareholdings) within the meaning of Article 85 of Directive 2001/34/EC;

15 Article 46a (1) of the Fourth Directive in Appendix I

- The holders of any securities with special control rights and a description of those rights;
- Any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, deadlines for exercising voting rights, or systems whereby, with the company's cooperation, the financial rights attaching to securities are separated from the holding of securities;
- The rules governing the appointment and replacement of Board members and the amendment of the articles of association;
- The powers of Board members, in particular the power to issue or buy back shares.

e) Unless the information is already fully provided for in national laws or regulations, the operation of the shareholders' meeting and its key powers, and a description of shareholders' rights and how they can be exercised;

f) The composition and operation of the administrative, management and supervisory bodies and their committees".

EU Member States[16] may permit companies which have only issued securities other than shares admitted to trading on a regulated market to limit the information included in their corporate governance statement to:

- the information related to the reference to the corporate governance code;
- the comply or explain approach; and
- the corporate governance structure

unless such companies have issued shares which are traded in a Multilateral Trading Facility.

4.3. Other elements that might be included in corporate governance statements

The above describes the minimum requirements imposed by the Fourth and Seventh Directives. EU Member States may recommend or require other types of information to be disclosed in the corporate governance statement. Companies may also decide to disclose other elements in their corporate governance statements on a voluntary basis. Consequently, the statement can include only the minimum elements required by the Fourth and Seventh Directives or it may also include additional information laid down by national law or national corporate governance codes.

[16] Paragraph 2 of the Article 46a of the Fourth Directive.

Additional elements, over and above the statutory requirements of the Fourth and Seventh Directive, identified in survey responses include:

- Remuneration report;
- An activity report on Board and Board's committees meetings;
- Internal Control Statement by the Board of Management;
- Company's objectives;
- Governance structures and policies and the process by which it is implemented;
- The financial and operating results of the company;
- Foreseeable risk factors: operational risks, compliance with laws and regulations, and financial risks;
- Disclosure that the corporate governance statement has been made accessible to the shareholders;
- A statement on whether the listed company has applied the principles of the code, in a manner that would enable shareholders to evaluate how the principles have been applied;
- Related-party transactions; and
- Conflicts of interest between personal interests of the directors and the business interest of the company itself.

In the 2003 *FEE Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance*, Chapter 6, FEE concluded that the corporate governance statement should include certain topics in addition to those required by Article 46a of the Fourth Directive. Equivalent elements arising from the analysis of the responses to the survey were:

- Discussion of the company's goals and progress in achieving them;
- Reports by the audit, remuneration and nomination committees on their activities;
- Comments on strengths and resources of the business in relation to its objectives;
- Information on the audit committee's responsibilities and activities.

4.3.1. Internal control considerations

The 2003 FEE Discussion Paper also raised issues related to risk management and internal control systems: *"The process Boards have undertaken to manage risk and assess internal control: identified main risks and uncertainties affecting the company; how the potential impacts of risks are managed; how directors will aim to improve operational performance of the company"*. These issues were addressed in the 2005 *FEE Discussion Paper on Risk Management and Internal Control in the EU*. At that time FEE queried the usefulness of introducing across the EU published effectiveness conclusions on internal control over financial reporting as required by Section 404 of the Sarbanes-Oxley Act. FEE added in its 2006 *FEE Analysis of Responses to the 2005 FEE Discussion Paper* that the debate on risk management and internal control needed to remain open for the time being, particularly in view of the differences between the US and the European approaches.

The 2006 Directive amending the Fourth and Seventh Directives calls for a description of the main features on internal control and risk management systems. There is no requirement to publish any statement or disclose information on the effectiveness of internal control and risk management systems.

4.3.2. Audit committees

Another element that may form part of the corporate governance statement referred to in the 2003 FEE Discussion Paper is the information related to the audit committee's membership, resources and training of the audit committee, self-assessment and its terms of reference. Section 3.4.2 of Chapter 3 summarises the requirements of Article 41 of the Statutory Audit Directive of 17 May 2006 in the area of audit committees. Companies may be required to, or wish to, disclose what their policies and procedures are in this area.

Currently FEE is undertaking a project on the implementation of Articles 37, 38 and 41 of the Statutory Audit Directive and the relationship between Auditor and Audit Committee. It expects to issue a discussion paper on this topic in the near future.

4.4. Main results of the FEE Survey on Elements included in Corporate Governance Statements

The responses to the questions in the survey concerning the establishment of a corporate governance statement including its elements and the type of reporting indicate that, in most countries, the Board of publicly traded (listed) companies is required to issue a corporate governance statement in/or outside the annual report. In some countries a corporate governance statement is issued on a voluntary basis following best practices, pending the transposition of the 2006 Directive amending the Fourth and Seventh Directives.

The minimum information required to be included in a corporate governance statement by the 2006 Directive amending the Fourth and Seventh Directives (Section 3.2.2.1.) is currently also required or best practice in many European countries. However, some variances exist. Examples of practices in a number of EU countries are included hereafter:

- France - The Chairman is obliged by law to describe the internal control system in a separate report (*"Rapport du Président"*) attached to the management report whereas other information of the statement is generally included in the *"Document de reference"* (registration document) filed with the securities commission;

- Netherlands - In The Netherlands the Corporate Governance Code (based on the comply or explain principle) requires the Board of Management to disclose in the annual report an *In control statement* on financial reporting risks as follows:

  "As regards financial reporting risks the management board states in the annual report that the internal risk management and control systems provide a reasonable assurance that the financial reporting does not contain any errors of material importance and that the risk management and control systems worked properly in the year under review. The management board shall provide clear substantiation of this." (Best practice provision II.1.5);

- UK - Boards are required by the Combined Code to report that they have conducted a review of the effectiveness of the group's system of internal controls (including financial, operational and compliance controls and risk management systems. The Turnbull Guidance sets out in more detail what the Board's statement on internal control should contain.

When the Board reports on the company's corporate governance practices in a corporate governance statement, generally, the "comply or explain" format is used. However, a full descriptive corporate governance statement is issued in for example Bulgaria, the Slovak Republic and Spain. For instance in Cyprus, France, Belgium and the Netherlands, the corporate governance statement is normally a combination of a full descriptive report and a 'comply or explain' report. In Ireland and UK for example, the statement contains information related to the way the listed company has applied the principles and a 'comply or explain' report on the code's provisions.

Regardless of the type of reporting, the corporate governance statement is, generally, disclosed in a separate section of the annual report and can or must also be disclosed on the company's website:

(a) In France, the description of the system of internal control is included in a report separate from the management report whereas the other corporate governance statements are included in a report filed with the securities commission ("AMF");

(b) In Germany for example, at the time of the survey the so-called 'declaration of conformity' by management and the supervisory board that the company has complied with the recommendations of the applicable corporate governance code or which recommendations they have not complied with was made available to the shareholders outside of the management report. Effective 2009 German legislation has been changed in order to introduce a corporate governance statement with extended information (such as "comply and explain" as well as other information required by Article 46a of the Fourth Directive) and companies may choose whether to include the statement in the management report or to publish it on their website. However, this right to choose is limited for some information stated in Article 46a. According to the German Commercial Code,

some information must form part of the management report (such as information on take-over bids and the description of the main features of the accounting-related internal control and risk management system) or must be included in the notes (such as the composition of management and supervisory board);

(c) In The Netherlands the reporting of Corporate Governance information needs improvement. The overall conclusion of research regarding the disclosure of risk management information indicated that:

"Risk management is a frequently debated topic in the corporate governance world. We observe that the topic receives more and more attention in financial reporting, which is a positive development. However, based on the results of this research we conclude that none of the public companies report on all aspects of risk management. Furthermore, our empirical research has revealed, that disclosure practices regarding risks and internal control systems show a wide diversity regarding:

1. The level of detail;
2. The description of the risks and control systems;
3. The quality and the scope of the 'in-control'-statement" (source: Inzicht in Onzekerheid, 2008, NIVRA en Eumedion).

Although corporate governance codes are often recommended for listed companies, or even endorsed by the stock exchange, by a regulator or by national legislation, in a significant number of European countries, codes are not binding. The common elements of a good practice corporate governance statement identified in Table 2 are derived from the FEE survey. However, these elements could have a different meaning in different European countries depending on interpretation in and linkage to the overall national legal framework. On the other hand, there may be other elements which are not identified in Table 2 but which are good practice in a more limited number of European countries or may soon become more commonly reported on.

Table 2 - Common elements of a good practice corporate governance statement in Europe

Although Table 2 below shows elements common to most corporate governance statements across Europe derived from the responses to the FEE survey, these elements may be different in some EU Member States and may have a different content than illustrated below. In other EU Member States, some of these elements may be binding because they are required by law or regulation, and therefore the corporate governance statement in respect of these elements is made on a mandatory basis.

The common elements contained in Article 46a of the 2006 Directive amending the Fourth and Seventh Directives are shown in bold.

Common elements of a good practice corporate governance statement in Europe
Provisions from the Fourth and Seventh Directives as amended:
A - Reference to the corporate governance code to which the company is subject
B - An explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so: 'comply or explain'
C - A <u>description</u> of the main features of the company's internal control and risk management systems in relation to the financial reporting process
<u>c.1 Internal control and risk management systems</u> The Board should maintain a sound system of internal control and risk management to safeguard shareholders' investment and the company's assets. The Board should issue a statement that it is responsible for monitoring the company's internal control and risk management systems and for reviewing their effectiveness.
D - Information required under the Takeover Bids Directive when the company is subject to this Directive The companies subject to the Takeover Bids Directive should also include information about direct and indirect shareholdings, the rights or restrictions on voting, the rules governing the appointment and replacement of the Board and the power of the Board members.
E - The operation of the shareholders' meeting and its key powers, and a description of shareholders' rights and how they can be exercised
<u>e.1.Dialogue with shareholders and other stakeholders</u> There should be a dialogue with shareholders and other relevant stakeholders based on the mutual understanding of objectives. The Board as a whole should have responsibility for ensuring that a satisfactory dialogue with shareholders and other stakeholders takes place.
<u>e.2.Constructive Use of the Annual General Meeting (AGM)</u> The Board should use the AGM to communicate with investors and to encourage their participation. The company should facilitate the use by shareholders of their votes.
F - The composition and operation of the administrative, management and supervisory bodies and their committees (or Supervisory Board and Management Board)
<u>f.1.Effective Board</u> Every company should be headed by an effective Board, which is collectively responsible for the performance of the company.
<u>f.2.Chairman and Chief Executive: clear division of responsibilities</u> Clear division of responsibilities at the top of the company between chairing the Board and the executive responsibility for managing the company's operations. No one individual should have unfettered powers of decision.
<u>f.3.Board balance and independence</u> - The Board should include a balance of composition of directors. - *Commonly codes refer to a balance between executive and non-executive directors (and in particular independent non-executive directors). Some codes go further and refer to a balance of gender, qualifications, experience and background.* - There should be procedures to ensure that no individual or small group of individuals can dominate the Board's decision taking.

Common elements of a good practice corporate governance statement in Europe
f.4.Procedure for appointments to the Board There should be a formal and transparent procedure for the appointment of new directors to the Board. Proposals on the election and remuneration of the board of directors should be prepared in a structured, transparent process. The task of the nomination committee should be to consider proposals made by the relevant parties and make a recommendation or provide advice for the appointment of the members of the Board.
f.5.Information and professional development - The Board should be supplied in a timely manner with information. - The information supplied to the Board should be in a form and of a quality appropriate to enable it to discharge its duties. - All directors should receive training on joining the Board and should regularly update and refresh their skills and knowledge.
f.6.Performance evaluation of the Board The Board should undertake a formal annual evaluation, e.g. of its performance and that of its committees and individual directors.
f.7.Re-election of the Directors - All directors should be submitted for re-election at regular intervals. - All directors should be subjected to continued satisfactory performance. - The Board should ensure planned and regular changes in Board's membership.
f.8.Remuneration of the Directors and Board policy and level[17] - Directors' remuneration policy: Listed companies should disclose a statement of the remuneration policy on directors of the company including the preparatory and decision making process used. - Disclosure of the remuneration of individual directors: The total remuneration and other benefits granted to individual directors should be disclosed in detail in the financial statements or in the notes or, where applicable in a separate remuneration report.
f.9.Audit committee and Auditors[18] The audit committee monitors: - The financial reporting process; - The effectiveness of the company's internal control and risk management systems, the internal audit function where applicable; - The statutory audit of the annual and consolidated accounts; and, - Reviews and monitors the independence of the statutory auditor or firm and particularly the provision of additional services.
f.10. Other Committees - The Board should stipulate formal procedures for the work of the Board and its committees. These procedures should be clear and well documented. - Depending on the specifics of the enterprise and the number of its members, the Board should form committees with sufficient expertise. They should be aimed at increasing the efficiency of the Board's work and the handling of complex issues.
f.11 Reporting - The Board should present a balanced and understandable assessment of the company's position and prospects (year-end).

[17] EC Recommendation on the remuneration of directors of listed companies of 14 December 2004 (2004/913/EC).

[18] Art 41 of the Statutory Audit Directive of 17 May 2006 (2006/43/ED). The directive provides that, in some cases, the functions of the Audit Committee may be discharged by another body.

Common elements of a good practice corporate governance statement in Europe
- The quality of the reporting should be ensured in the form of policies, instructions for responsibility distribution. - The Board's responsibility should extend to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements (interim). - In addition, the Board should establish formal and transparent arrangements for assuming responsibility for the preparation of the Board's work to ensure the quality of the company's financial reporting, for considering how they could apply the financial reporting and internal control system and for maintaining an appropriate relationship with the statutory auditors.
G - Elements from the survey in addition to those addressed in the 2006 Directive amending the Fourth and Seventh Directives in relation to corporate governance statements g.1. Present an activity report on Board and Board's committees meetings; g.2. Mention company's objectives; g.3. Disclose governance structures and policies and the process by which they are implemented; g.4. Present the financial and operating results of the company; g.5. Define the foreseeable risk factors: operational risks, compliance with laws and regulations, and financial risks; g.6. Information as to where any separate corporate governance statement has been made accessible to the shareholders; g.7. Statement as to how the listed company has applied the principles of the code, in a manner that would enable shareholders to evaluate how the principles have been applied; g.8. Disclose related-party transactions[19]; and g.9. Mention of conflicts of interest: personal interests of the directors and the business interest of the company itself.

4.5. Location of disclosures

The Directives specify that the corporate governance statement is normally included within the Annual Report (management report), but permit Member States to give the option of presenting a separate statement. This can lead to confusion because the term "annual report" is used differently in legislative and practical circumstances.

In practice, the term "annual report" is usually understood to be the "glossy" document issued by companies in order to inform the wider public about all their activities which include both financial and non-financial information. Generally, this document contains the audited financial statements (which include the balance sheet, income statement (profit and loss account), cash flow statement and related notes), the auditor's report, and management report. It may also include other information, either voluntarily or because of local laws, regulations or other requirements. Examples of such information include, but are not limited to, an operating and financial review of the operations of the company and its future prospects, a corporate

[19] It is also mentioned in Article 7 of the 2006 Directive amending the Fourth and Seventh Directive.

governance statement (prepared in accordance with an existing code or law), a sustainability report and a remuneration report.

However, in European legislation the use of the term "annual report" might be confusing as it is used in different ways. In addition to the annual report as addressed by the Fourth and Seventh Directives, there is the term "annual financial report" as addressed by the Transparency Directive.

The distinction between the "annual report" and the "annual financial report" may not always be fully understood in practice:

- The "annual financial report" refers to a document containing the audited financial statements, the management report, as well as the responsibility statement required by the Transparency Directive[20]. According to the Transparency Directive the auditor's report on the financial statements shall be published together with the annual financial report. However, the "glossy" document sent to shareholders contains more information than the annual financial report;

- The management report in the Transparency Directive has the same meaning as the "annual report" in the Fourth and Seventh Directives[21] i.e. the report of the Board covering certain specific numeric and narrative disclosures on the development and performance of a company's business and position required by European law.

In the IAASB's standards, references to the term "annual report" can be understood either as the "annual financial report" or the "glossy" document as described above.

4.6. The annual report as defined by Article 46a of the Fourth and Seventh Directives and the management report as defined by the Transparency Directive

Article 46 of the Fourth and Seventh Directives (and Article 4, (5) of the Transparency Directive) defines the annual report (management report) as a document that must, at least, include the following information:

(a) "A fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces. The review shall be a balanced and comprehensive

[20] The term 'responsibility statement' refers to the statement required by Article 4 (2), c) of the Transparency Directive: "*2. The annual financial report shall comprise: (...)*
(c) statements made by the persons responsible within the issuer, whose names and functions shall be clearly indicated, to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole and that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face."

[21] Article 4 (5) of the Transparency Directive: "*The management report shall be drawn up in accordance with Article 46 of Directive 78/660/EEC and, if the issuer is required to prepare consolidated accounts, in accordance with Article 36 of Directive 83/349/EEC*".

analysis of the development and performance of the company's business and of its position, consistent with the size and complexity of the business;

(b) To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters[22];

(c) In providing its analysis, the annual report shall, where appropriate, include references to and additional explanations of amounts reported in the annual accounts;

(d) The report shall also give an indication of:

 (a) any important events that have occurred since the end of the financial year;

 (b) the company's likely future development;

 (c) activities in the field of research and development;

 (d) the information concerning acquisitions of own shares prescribed by Article 22 (2) of Directive 77/91/EEC[23];

 (e) the existence of branches of the company;

 (f) in relation to the company's use of financial instruments and where material for the assessment of its assets, liabilities, financial position and profit or loss:

  - the company's financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used; and

  - the company's exposure to price risk, credit risk, liquidity risk and cash flow risk."

The annual report is subject to a consistency check by the statutory auditor, in compliance with Article 51 of the Fourth Directive: he has to express an opinion concerning the consistency or otherwise of the annual report (management report) with the financial statements.

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[22] The Fourth Directives provides that Member States may choose to exempt companies covered by Article 27 from the obligation in paragraph 1(b) above in so far as it relates to non-financial information.

[23] Article 22 (2) of Directive 77/91/EEC: "*Where the laws of a Member State permit a company to acquire its own shares, either itself or through a person acting in his own name but on the company's behalf, they shall require the annual report to state at least:*
(a) the reasons for acquisitions made during the financial year;
(b) the number and nominal value or, in the absence of a nominal value, the accountable par of the shares acquired and disposed of during the financial year and the proportion of the subscribed capital which they represent;
(c) in the case of acquisition or disposal for a value, the consideration for the shares;
(d) the number and nominal value or, in the absence of a nominal value, the accountable par of all the shares acquired and held by the company and the proportion of the subscribed capital which they represent."

5. THE INVOLVEMENT OF THE AUDITOR WITH THE CORPORATE GOVERNANCE STATEMENT

5.1. Introduction

Earlier sections of this Discussion Paper discussed:

- Corporate governance principles and rules – those principles commonly seen in European corporate governance codes and certain minimum requirements of European law; and
- Corporate governance statements – practices commonly seen across Europe and certain minimum requirements of European law.

This section of the paper now considers the auditor's involvement with the corporate governance statement:

- The minimum requirements of European law, and how these might be addressed; and
- Possible wider involvement of the auditor (whether statutory auditor or other independent and suitably qualified practitioner).

5.2. Possible forms of auditor involvement

Before considering auditors' involvement, it is useful to consider what forms of work an auditor may perform in accordance with professional standards issued by the International Auditing and Assurance Standards Board.

The IAASB issues the following types of standard:

- International Standards on Auditing (ISAs) are to be applied, as appropriate, in the audit of historical financial information;
- International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information;
- International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information;
- International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.

The first three of these types of standards deal with forms of assurance engagement; ISRSs deal with non-assurance engagements.

5.2.1. What is an assurance engagement?

An assurance engagement means an engagement in which a practitioner, also referred to as a professional accountant in public practice, expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter (e.g. the corporate governance of a company or a company's financial position) against criteria. Assurance engagements may be at one of two levels[24]:

- Reasonable assurance engagements — The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion (e.g. annual audits);

- Limited assurance engagements — The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, as the basis for a negative form of expression of the practitioner's conclusion. The assurance engagement risk of a limited assurance engagement is greater than for a reasonable assurance engagement (e.g. interim review).

In order for the performance of an assurance engagement to be possible, criteria to compare the subject matter information (e.g., a company's report or statement on corporate governance or a company's financial statements) against are needed which exhibit the following characteristics[25]:

(a) Relevance: relevant criteria contribute to conclusions that assist decision-making by the intended users;

(b) Completeness: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure;

(c) Reliability: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners;

(d) Neutrality: neutral criteria contribute to conclusions that are free from bias.

Understandability: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

[24] The definitions of the two levels of assurance engagement are taken from the IAASB's Glossary of Terms as revised in December 2007.

[25] Paragraph 36 of the IAASB's International Framework for Assurance Engagements.

5.2.2. What is a related services engagement?

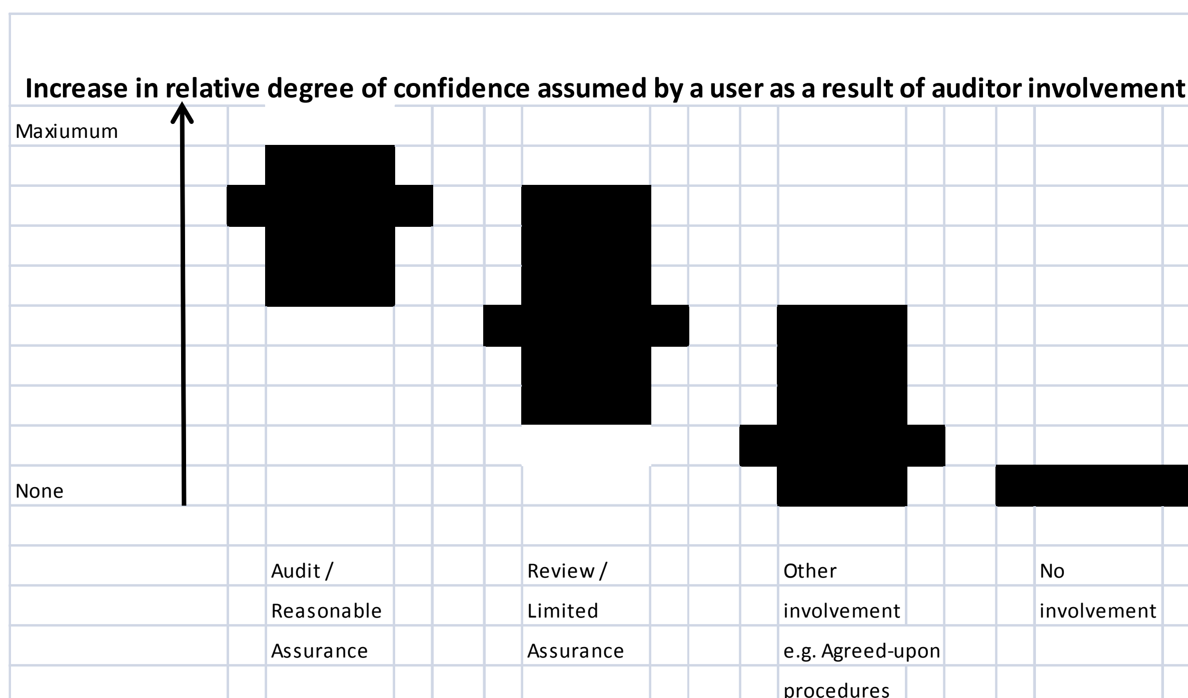
By contrast, related services engagements (ISRSs) do not lead to the practitioner or auditor expressing a conclusion. One of the most common forms of these engagements are agreed-upon procedures engagements in which an auditor is engaged to carry out specific procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. An agreed-upon procedures report states that it does not express assurance. Instead, users of the report assess for themselves the procedures and findings reported and draw their own conclusions.

Whilst the auditor does not express a conclusion, and hence this is not an assurance engagement, FEE believes that the users of such report may have an enhanced degree of confidence about the subject matter as, whilst they are forming their own conclusion, they do so in the knowledge that the facts on which they base their conclusion have been the subject of checks by an independent and suitably qualified practitioner.

5.2.3. What is the difference in the degree of confidence which a user may draw from the different types of auditor's involvement?

The different levels of auditor involvement described to above will enhance the confidence of the user of the information being reported on by different degrees. It is hard to quantify this in absolute terms. In addition, no specific research has been carried out in terms of work on corporate governance statements. However, IFAC has recently published a consultation paper, commissioned by the IAASB, *"Matters to Consider in a Revision of International Standard on Review Engagements (ISRE) 2400, Engagements to Review Financial Statements"* [26]*,* which cited previous studies on the degree of confidence expressed by users of financial information which had been subject to different types of auditor involvement. These give a useful indication of the possible relative increase in confidence from different types of engagement – although, in practice, different levels of confidence may be assumed by users of reports depending on the nature of the subject matter, national practice and the wording of the report.

[26] http://www.ifac.org/Guidance/EXD-Details.php?EDID=0118



The diagram above, developed by FEE, is an attempt to indicate the range of the increase in the degree of confidence which a user might have as a result of the auditor's involvement with a company's corporate governance disclosures. The key points to note are:

- Because even a reasonable assurance engagement involves inherent limitations, including some element of judgment, no practitioner can obtain absolute assurance;
- The level of confidence drawn by those reading assurance engagement reports will differ between different subject matters with the same type of engagement, and may also differ from entity to entity;
- Generally, assurance engagements, which involve the expression of an opinion, enable users to draw more confidence than those which are limited to purely factual matters.

5.3. Minimum involvement of the auditor under EU law and International Standards on Auditing

5.3.1. ISA 720 Other Information in Documents Containing Audited Financial Statements

If a corporate governance statement is included in a document containing audited financial statements, then ISA 720[27] requires that, in summary:

- The auditor should read the other information to identify material inconsistencies with the audited financial statements;
- If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended;
- If an amendment is necessary in the audited financial statements as a result of an identified inconsistency and the entity's management refuses to make the amendment, the auditor should express a qualified or adverse opinion;
- If an amendment is necessary in the other information and the entity refuses to make the amendment, the auditor should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions;
- If the auditor becomes aware that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management;
- When the auditor still considers that there is an apparent misstatement of fact, the auditor should request management to consult with a qualified third party, such as the entity's legal counsel and should consider the advice received;
- If the auditor concludes that there is a material misstatement of fact in the other information which the entity's management refuses to correct, the auditor should consider taking further appropriate action.

FEE takes from these requirements that, regardless of other law or regulation, the auditor does have some duties in respect of the corporate governance statement that is included in the document containing the financial statements. But these are limited because:

- The auditor's consideration is one of material inconsistency with the financial statements. Many elements of a corporate governance statement will have little or no overlap with the financial statements;

[27] This description summarises the requirements of both ISA 720 and ISA 720 (redrafted).

- The auditor's consideration of material misstatements of fact is limited only to those of which the auditor becomes aware; the auditor does not need to go looking for them, nor to prove that there are none. But the auditor cannot ignore potential material misstatements that he or she is aware of.

The fact that auditors need not seek out supporting evidence does not mean that they will knowingly allow wrong or misleading reporting to be included in a document with which their name is associated. IFAC Code of Ethics for Professional Accountants sets out in section 110 *Integrity* that:

"A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading."

Auditors must therefore take action if they become aware of reporting in a document published with their audit report and the audited financial statements if they believe that it is false or misleading. This could be both by actively including a statement that is wrong, or by inappropriately omitting information so as to give a misleading impression. For example, if a corporate governance statement says that the audit committee meets every quarter, but the auditor has already been told that it only meets once a year then he or she will need to raise the matter with management and/or those charged with governance and seek to have the disclosure amended. Similarly, whilst the auditor need not explicitly check for consistency between parts of the annual report other than the financial statements (e.g. the annual report (management report) and a sustainability report), he or she cannot ignore a potential material inconsistency or misstatement between that information and the financial statements that he/she has become aware of.

5.3.2. The minimum requirements for auditor involvement with corporate governance statements under EU law

The 2006 Directive amending the Fourth and Seventh Directives provides a specific role for the statutory auditor related to the corporate governance statement. The precise role differs depending on the location of the corporate governance statement:

- If under Article 46a(1) of the Fourth Directive, the corporate governance statement is included in the annual report (management report), Article 51 of the Fourth Directive requires the statutory auditor to express an opinion on the consistency or otherwise of the annual report (management report) with the annual accounts. The majority of Member States have interpreted this as meaning that the statutory auditor's opinion required by the Directive covers consistency of the whole of the corporate governance statement within the annual report (management report) with the annual accounts;

- Under Article 46a(2) of the Fourth Directive and Article 36(2) of the Seventh Directive, EU Member States may permit companies to issue a separate report including the information required in a corporate governance statement. In this situation, Article 46a(2) requires that the statutory auditor's duty to issue a consistency opinion referred to above under Article 51 is applied to two elements of the statement:

  - A description of the main features of the company's internal control and risk management systems in relation to the financial reporting process; and

  - The information required by Article 10(1), points (c), (d), (f), (h) and (i) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on take-over bids.

  For the remaining information in the separate corporate governance statement, the statutory auditor shall *check* that the governance statement has been produced.

Therefore, the level of work required by the auditor, and degree of confidence that users of the financial statements can derive from the auditor's involvement, will vary depending on:

- Whether the corporate governance statement is included within the annual report (management report), or published elsewhere within the annual financial report ("glossy"), or issued as a stand-alone document;

- Whether the relevant Member State has gone beyond the requirements of the Fourth and Seventh Directives and made all or some of the information contained within the annual report (management report) subject to review or audit;

  - In such situations where the annual report (management report) is subject to audit and where the corporate governance statement is not a separate report but is part of the annual report, the corporate governance statement will be subject to review or audit. Where it is a separate report, there may still be a greater level of work required of the auditor as the auditor will be aware of more information from auditing the annual report (management report) and hence more likely to be able to identify apparent misstatements;

- The way that the requirements of the Directives have been transposed into Member State law. The language used in their law to set out the requirements for auditor involvement in the directive minimum corporate governance area will require an opinion on consistency. In the case of checking that information has been produced, it may require an opinion or reporting of factual findings, either explicitly (one way or the other) or by exception (only if information has not been produced), in the areas where the Directive requires, statutory auditor involvement in corporate governance.

The requirement to consider consistency and form an opinion has been in place for the annual report (management report) since 2005, but the requirement to check that something has been produced is a new one. The Directive does not specify the level of work required to perform a check that information has been produced ("production

check"), nor does it directly appear necessarily to require a positive or negative mention in the auditor's report.

Some Member States have transposed the requirements for a production "check" using words implying a purely factual check – for example, that the information has been "established" (France). In the Dutch translation of the 2006 Directive amending the Fourth and Seventh Directives, the word "provided" was used, although this was not transposed as such in the Netherlands. It is likely that this duty could be dealt with as a factual finding – either reporting positively, or reporting by exception if it is not the case. Some Member States, like Belgium, have, by contrast, required an opinion.

An opinion could be considered to require a significantly different level of work, as an assurance engagement carried out in accordance with ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* requires, amongst other things:

- A planning stage (to consider risks of material misstatement, including understanding of the entity and the internal control relevant to production of the subject matter information);

- Performing of procedures to address identified risks; and

- Forming of a conclusion.

In practice, however, it should be possible to construct acceptable criteria, meeting the requirements of the IAASB Framework for Assurance Engagements, such that the work required is little different from that required to perform a purely factual check that information has been produced: the subject matter information is the corporate governance statement and the criteria could be "whether the corporate governance statement includes the materials required by [applicable law or regulation]".

In both cases, when explaining the criteria to users, it may be beneficial to add a statement that the auditor has not verified the subject matter information to supporting documentation, enquiries of management or other external information. Alternatively, this could be clarified in an appropriate professional standard to which the report could refer.

5.4. Potential auditor involvement in the corporate governance statement over and above that required by EU law

A number of EU Member State laws and/or national standards already require auditor involvement with corporate governance disclosures (whether required by law, regulation or corporate governance codes) above and beyond the minimum EU directive requirements described above. For example:

- Denmark – For financial years beginning before 1 September 2008, the auditor has been required to perform an audit of the annual report including both the financial statements and the management report. The statement on corporate governance which listed companies have published as part of the management report in accordance with the disclosure requirements of the Copenhagen Stock Exchange

(now NASDAQ OMX Copenhagen A/S) has therefore been subject to audit according to procedures set out in Danish Auditing Standard 585 on the audit of the management report. For financial years beginning on or after 1 September 2008 the auditor is required to audit the financial statements but is not required to audit the management report. It will be sufficient for the auditor to read and perform consistency checks on the information in the management report – and to give an opinion on the consistency with the financial statements – in the auditor's opinion. Danish legislation now states explicitly that the auditor's opinion on the financial statements does not include the statement on corporate governance if this statement is published on the website of the company instead of in the management report. However, the auditor's opinion on the consistency of the management report must, if the information is provided on the website, include the check of the description of the main features of the internal control and risk management systems in relation to the financial reporting process. The Danish Institute is expected to issue examples of auditor's opinion in these different situations;

- Germany – Audit Standard regarding Impact of the Corporate Governance Code on the Statutory Audit which requires the auditor to report to the supervisory board on corporate governance information. As already explained in Section 4.4, information which according to the German Commercial Code must form part of the management report (such as information on take-over bids and the description of the main features of the accounting-related internal control and risk management system) or must be included in the notes (such as the composition of management and supervisory board) is subject to the audit of financial statements and management report;

- The Netherlands – The auditor's involvement with the audit committee and Supervisory Board and his or her reporting related to the operation of the internal risk management and control systems and the quality of the internal provisions of information, etc is included in the Dutch Corporate Governance Code (Frijns) which will become applicable at the end of 2009. The Audit Alert 18 is then expected to be withdrawn;

- Ireland/United Kingdom – The Listing Rules of the Financial Services Authority and the Listing Rules of the Irish Stock Exchange require that the auditor reviews the company's compliance with 9 of the 48 provisions of the Combined Code on Corporate Governance.

Common to all of these is a requirement for the auditor to perform more detailed factual checking and/or assurance procedures on certain elements of corporate governance reporting. In all cases there is a recognition that the work is required to be done by the statutory auditor.

There is nothing in EU law to preclude the involvement of another independent and suitably qualified practitioner in the provision of services relating to the corporate governance statement other than those included in the Fourth and Seventh Directives. Member States and/or national standard setters could mandate that the work is done by the statutory auditor, or leave it to a company's discretion. Equally, companies may voluntarily ask for work to be done on wider aspects of their corporate governance statements in order to enhance the degree of confidence, and ask for that work to be done by either the statutory auditor or another independent and suitably qualified

practitioner. Consideration of who should perform such work will involve a balance of considerations including:

- The degree of overlap between the work required in respect of the particular corporate governance elements being reported on and the knowledge the statutory auditor already has from his or her audit of the financial statements (and, in certain countries, the annual report (management report));

- Whether the statutory auditor has the right mix of skills, knowledge and experience to perform the work, or whether another practitioner is more suitable or qualified;

- Whether the statutory auditor is permitted to perform the work by national independence rules and, conversely, whether any other practitioner is sufficiently independent; and

- Whether the findings and/or conclusions are to be presented together with the report on the audited financial statement.

A range of practices is seen in European countries. In the country examples given above, the work must be performed by the auditor – common subject matter of such engagements are matters such as whether the auditor's existing knowledge will enable the work to be conducted both efficiently and effectively, including areas such as internal control over financial reporting. Common examples of the use of someone other than the statutory auditor to perform work are in connection with the aspects of corporate governance relating to a company's corporate and social responsibility and sustainability; such subject matter is less likely to overlap with the statutory auditor's knowledge obtained through the audit of the financial statements.

The form of such engagements differs significantly as well:

- Some engagements involve purely factual checks. For example, the auditor could check that reported disclosure around the composition of various board committees and directors' attendance at meetings agrees to minutes of those meetings, or that there is a whistle-blowing hotline included in the staff handbook;

- Some engagements involve limited assurance engagements. For example, in the UK listed companies are required to report on compliance with the Combined Code (or explain why they have not complied individual provisions in the Code) and auditors are required to review compliance with 9 of the 48 specific provisions. These are all closely related to work already carried out by the auditor. The auditors carry out a limited assurance engagement and, assuming they do not find any misstatements, report that they have not found anything to report;

- Some engagements involve reasonable assurance over certain governance information. Other than for the consistency checks required by law, these are less common. They require a subject matter which is reported on in subject matter information with suitable criteria. For example:

    - In many countries, the consistency check required by the Fourth and Seventh Directives has been implemented using words which require a positive expression of opinion;

- o In Germany, the notes to the financial statements must disclose the composition of the management board and supervisory board; accordingly, this information is subject to audit;

- o In the UK disclosures regarding directors' remuneration paid during the previous year require audit. The subject matter is the pay of directors, the subject matter information is the audited portion of the remuneration report, and the criteria for evaluation are the legal requirements for the content of a remuneration report. In contrast, the disclosures relating to future remuneration policy are not as these are inherently subjective.

5.5. Factors to be considered in deciding whether particular corporate governance statement elements should be reported on

The information in a corporate governance statement covers many different matters. The degree of involvement by the auditor will vary considerably and factors to be considered by regulators considering imposing requirements on all companies, or companies volunteering to have information reported on, include:

- Whether the information is objective or subjective. Some information in a corporate governance statement is subjective and unlikely to be capable of objective verification by an auditor. Examples of such information are those that are forward looking or strategic. It is less likely that suitable criteria (see Section 5.2 above) can be developed to enable the auditor to carry out an assurance engagement. For example, it is unlikely that an auditor will be able to form an opinion as to whether a company's strategy is appropriate; again though, it is unlikely that shareholders will want this as they form this view themselves based on their view of management's skill, the economic environment and other factors;

- The nature of the information. This affects whether assurance is possible and cost-effective. For example, FEE carried out an extensive study of internal control, published in the FEE Discussion Paper on Risk Management and Internal Control in the EU. In that paper, FEE noted that disclosures by management about internal control over financial reporting, and about wider aspects of internal control, provided useful information to shareholders. It may be possible for directors to form a conclusion as to the effectiveness of internal control if suitable criteria could be identified, such as COSO-ERM. However, it is likely to be significantly more expensive than reporting just a description of the key features of a system of internal control and therefore less likely to meet any cost/benefit test. The same considerations would apply for auditor's involvement – carrying out an assurance engagement as to whether a description of the key features of internal control over financial reporting fairly reflected a company's actual internal control integrates with some of the work already performed by the auditor in carrying out an audit in accordance with the ISAs and may increase the user's degree of confidence in the financial reporting issued by the company. Broadening this out to wider aspects of internal control may be less cost-effective as the auditor may not have as much knowledge of the company's controls in other areas. Requiring the auditor to report on effectiveness will in turn require the company to conclude

on effectiveness, requiring both management and the auditor to incur time and expense to carry out significant amounts of testing;

- Some information may be factually verifiable, but the shareholders may be equally well placed to verify the information themselves. For example, some codes require that a certain notice period is provided for the annual general meeting. Whilst the auditor could verify this, the shareholders can do so as well;

- Some information is particularly well-suited to auditor involvement and may provide useful additional information to shareholders. For example, some corporate governance statements include key numerical indicators of performance in non-financial areas. The source information for this is not available to the shareholders, but is to the auditor. The auditor can carry out testing of the compilation of the data, including checking back to source documentation. Where this data is key to understanding the company's business model and governance, the company may benefit from the increased degree of confidence arising from auditor involvement.

6. FEE'S VIEW AS TO THE POTENTIAL MAXIMUM LEVEL OF AUDITOR INVOLVEMENT IN KEY AREAS OF CORPORATE GOVERNANCE

FEE has considered whether, for certain elements of the corporate governance statement, it is possible to carry out an engagement of one of the following forms:

- Factual findings by the auditor. This could include a simple check that information has been produced, without checking to any supporting information. It may also extend to engagements to check specific factual aspects of the information being reported – for example, agreeing a list of directors and committee members to board minutes and filings on the public record;
- A limited assurance engagement, providing an equivalent level of assurance to the review of a half-yearly financial report. The performance of a limited assurance engagement is only proposed for elements of a corporate governance statement on which performing procedures such as inquiry of company's management and analytical procedures would be meaningful; or
- A reasonable assurance engagement, providing an equivalent level of assurance to an audit of annual financial statements. The performance of a reasonable assurance engagement is generally only proposed for elements of a corporate governance statement which consist of numerical information.

As discussed in Section 5.3.2 above, checking that information has been produced may be done as a factual finding, but it may also be possible to provide criteria which allow such engagements to be carried out as an assurance engagement. Checking the consistency of one set of information with another set of information is likely to be an assurance engagement, as it requires judgment by the auditor. This will be a reasonable assurance engagement, at least as far as the information required by the EU company law directives, but could be limited or reasonable assurance for other information depending on how the work is performed and reported. In all cases, the other conditions for an assurance engagement set out in the IAASB Framework for Assurance Engagements will need to be met.

In the analysis below, the term "auditor" is used to mean an independent practitioner carrying out the work who is qualified to be an auditor of financial statements, but not necessarily the statutory auditor appointed to audit the financial statements. It could be the independent external auditor appointed to audit the company's or entity's financial statements ("statutory auditor") or another similarly qualified auditor, which is required following Articles 46a of the Fourth Directive and/or Article 36(2) of the Seventh Directive as discussed in Section 5.3.2 above. For cost/benefit reasons it may be appropriate for the statutory auditor to carry out the work if, for example, the work relates to information or knowledge that the auditor already has gained as part of his audit. Conversely, there are some areas where it is unlikely or impossible for the statutory auditor to be able to provide assurance – for example, in areas relating to the choice of statutory auditor. In other areas, it may depend on the skills of the practitioner concerned – some firms may specialise in some areas e.g. sustainability assurance.

Table 3 sets out the main areas covered in corporate governance statements across European countries, as identified in Chapter 3 of this Discussion Paper, and sets out FEE's view of the maximum, or highest, potential level of auditor involvement for each area. This is not an exhaustive list of possible areas in which engagements could be undertaken. It does include all of the areas listed in the Fourth and Seventh Directives (as amended) and those relating to the audit committee within the Statutory Audit Directive, as set out in Chapter 4 – these are highlighted in bold text in the table.

FEE's assessment of the highest potential level of auditor involvement indicates a maximum possible level of involvement from a cost/ benefit and theoretical perspective without expressing a preference for a particular level of assurance to be given in practice. In the case of assurance engagements, it will depend on the ability to identify suitable criteria to enable assurance to be given and to meet the other conditions for an assurance engagement set out in the IAASB's Framework for Assurance Engagements. Finally, the auditor's engagement risk may make some engagements prohibitively expensive – for example, were an auditor willing and able to accept an engagement to form an opinion on the effectiveness of internal control over strategic or other risks affecting the business, this would be likely to be very expensive given the level of work required to reduce risk to an acceptable level over such a broad subject matter.

FEE is not claiming that these levels of assurance are necessary, preferable or even desirable. Nor is FEE attempting to explain what procedures an auditor would need to perform to give assurance in each of these particular areas.

The levels of auditor involvement are those set out in Section 5.2 above and include both "limited" and "reasonable" assurance engagements, in which the auditor expresses a conclusion based on their work, and a factual findings engagement in which they do not. In practice, engagements in which the auditor considers "consistency" of the corporate governance report with other information (whether included in the financial statements or elsewhere) are likely to be assurance engagements. Engagements as to whether information has been "produced" may be constructed either as a factual findings engagement or as an assurance engagement (see Section 5.3.2 above).

Some of the statements of principle in Table 3 have been supplemented by explanatory text. To avoid potential confusion as to "assurance" provided on such explanations, as well as to highlight the "pure principle" of the element, the explanations have been separately delineated in an italicised paragraph.

In the table the term "Board" covers the Board of Directors, the Management Board or the Supervisory Board, depending on whether there is a single-tier or two-tier board structure.

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Table 3 – Potential maximum of auditor involvement level in key areas of corporate governance

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
	Corporate Governance Code					
A	**Reference to the corporate governance code to which the company is subject.**		X			The auditor can confirm to which code the company is subject.
B	**An explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so: 'comply or explain'.**		X		X	The maximum level of auditor's involvement will vary provision by provision, depending on whether he or she can form a view as to the entity's compliance with that provision.
C	**A description of the main features of the company's internal control and risk management systems in relation to the financial reporting process.**				X	Assurance is possible in this area where it relates to financial matters (see FEE's Discussion Paper *Risk Management and Internal Control in the EU*).

[28] In some EU Members States, the principles included in their corporate governance codes may differ from, and/ or have a different content than, those illustrated below. In other EU Member States, some of these principles may be binding because they are required by law or regulation, and, therefore, the corporate governance statement in respect of these principles may need to be made on a mandatory basis.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
c.1	<u>Internal control and risk management systems</u> - The Board should maintain a sound system of internal control and risk management to safeguard shareholders' investment and the company's assets. - The Board should issue a statement that it is responsible for monitoring the company's internal control and risk management systems and for reviewing their effectiveness.		X	X		Assurance is possible in this area where it relates to financial matters. It may be possible in other areas where suitable criteria exist, but they are less likely to be cost effective. This is discussed further in FEE's Discussion Paper *Risk Management and Internal Control in the EU*.
	<u>Takeover Bids Directive</u>					
D	**Information required under the Takeover Bids Directive when the company is subject to this Directive.** The companies subject to the Takeover Bids Directive also include information about direct and indirect shareholdings, the rights or restrictions on voting, the rules governing the appointment and replacement of the Board and the power of the Board's members.				X	The auditor can form a view as to whether the description in the statement is consistent with supporting information e.g. the company's constitution and/or shareholder agreements.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
	<u>Shareholders</u>					
E	**The operation of the shareholders' meeting and its key powers, and a description of shareholders' rights and how they can be exercised.**				X	The auditor can form a view as to whether the description in the statement is consistent with supporting information e.g. the company's constitution and/or shareholder agreements.
e.1	<u>Dialogue with shareholders and other stakeholders</u> There should be a dialogue with shareholders and other relevant stakeholders based on the mutual understanding of objectives. *The Board as a whole should have responsibility for ensuring that a satisfactory dialogue with shareholders and other stakeholders takes place.*		X			The auditor is unlikely to be present in meetings with individual investors, nor to be able to ask investors directly whether the company has discussed with them all the matters in which they are interested. The auditor could, however, check that a description of the process for doing this is operated in practice. This is already done in some sustainability reports under AA 1000 AS (2008).

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
e.2	Constructive Use of the Annual General Meeting (AGM) The Board should use the AGM to communicate with investors and to encourage their participation.		X			The auditor could check factual aspects e.g. what information was sent out prior to an AGM. However, this is less likely to be cost-effective as shareholders can check this for themselves.
	- The company should facilitate the use by shareholders of their votes.		X			The auditor could check that an electronic voting system is available or that pre-printed proxy forms and envelopes are made available. The auditor could also check whether a company contact to discuss notions with shareholders is made available.
F	**The composition and operation of the administrative, management and supervisory bodies and their committees (or Supervisory Board and Management Board)**					

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.1	<u>Effective Board</u> Every company should be headed by an effective Board, which is collectively responsible for the performance of the company.	X				It is unlikely that an auditor can form an opinion as whether the Board is "effective" but it would be possible to check factual aspects of the Board's explanation of why he or she felt they were effective e.g. the composition of the Board and the directors' attendance record for meetings.
f.2	<u>Chairman and Chief Executive: clear division of responsibilities</u> - Clear division of responsibilities at the top of the company between chairing the Board and the executive responsibility for managing the company's operations.		X			
	- No one individual should have unfettered powers of decision.	X				The auditor could, theoretically, say that there was a procedure to prevent one individual from exercising all decision making power. However, the auditor cannot check this in practice, or provide assurance, as a member of the audit team would have to be present in every board and executive meeting and observe how decisions were taken.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.3	<u>Board balance and independence</u> - The Board should include a balance of composition of directors *Commonly codes refer to a balance between executive and non-executive directors (and in particular independent non-executive directors). Some codes go further and refer to a balance of gender, qualifications, experience and background.*		X			
	- There should be procedures to ensure that no individual or small group of individuals can dominate the Board's decision taking.	X				The auditor could, theoretically, say that there was a procedure to prevent one individual or small group dominating decision taking. However, the auditor cannot check this in practice, or provide assurance, as a member of the audit team would have to be present in every board and executive meeting and observe what decisions were taken.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.4	<u>Procedure for appointments to the Board</u> There should be a formal and transparent procedure for the appointment of new directors to the Board. Proposals on the election and remuneration of the board of directors should be prepared in a structured, transparent process. *The task of the nomination committee should be to consider proposals made by the relevant parties and make a recommendation or provide advice for the appointment of the members of the Board.*		X			An auditor could check factual accuracy e.g. that a policy existed, that the nomination committee had met, and that recommendations to the board as stated in the board minutes were those made by the nomination committee.
f.5	<u>Information and professional development</u> - The Board should be supplied in a timely manner with information;		X			The auditor can check that the board papers include the information which the corporate governance statements says that they contain, and whether they were provided in the timescale that the statement says that they were. However, the decision as to what

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
	- The information supplied to the Board should be in a form and of a quality appropriate to enable it to discharge its duties.		X			is "timely" and is of a "quality appropriate to enable it to discharge its duties" is highly subjective and not capable of assurance.
	- All directors should receive training on joining the Board and should regularly update and refresh their skills and knowledge.		X			The auditor could factually check whether induction packs are given and confirm attendance at training events, seminars etc. to attendance records.
f.6	<u>Performance evaluation of the Board</u> The Board should undertake a formal annual evaluation, e.g. of its performance and that of its committees and individual directors.		X			The auditor can confirm factually that an exercise has occurred but forming an opinion as to whether the Board's assessment is "right" would require forming a view of effectiveness – see f.4 above.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.7	Re-election of the Directors - All directors should be submitted for re-election at regular intervals. - All directors should be subjected to continued satisfactory performance. - The Board should ensure planned and regular changes in Board's membership.		X X X			The auditor could factually confirm that a succession plan was in place, and that votes had actually taken place for re-election. He or she could not, however, form an opinion as to whether an individual directors' performance was satisfactory.
f.8	Remuneration of the Directors and Board policy and level - Directors' remuneration policy: Listed companies should disclose a statement of the remuneration policy on directors of the company including the preparatory and decision making process used.		X			The auditor could check factual aspects e.g. the accuracy of descriptions of future share option awards. However, the auditor is unlikely to form an opinion as to whether the policy is appropriate.
	- Disclosure of the remuneration of individual directors: The total remuneration and other benefits granted to individual directors should be disclosed in detail in the financial statements or in the notes or, where applicable in a separate remuneration report.				X	This information is historic financial information. Summary information is already audited when disclosed in the notes to the financial statements, either as a matter of law or because of IAS 24 which requires disclosure of the remuneration of key management personnel.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.9	<u>Audit committee and Auditors</u> *The Statutory Audit Directive provides that, in some cases, the functions of the Audit Committee may be discharged by another body.* The audit committee monitors:					Assurance is possible, but reasonable assurance is unlikely to be cost effective. See FEE's Discussion Paper *Risk Management and Internal Control in the European Union.* A suitable framework will be needed for management's assessment of risk and internal control.
	- The financial reporting process;			X		
	- The effectiveness of the company's internal control and risk management systems, the internal audit function where applicable;			X		

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
	- The statutory audit of the annual and consolidated accounts;			X		There is a need to avoid a self-review threat in that the auditor is forming a view on whether the audit committee's supervision of himself is effective. This could be done by carefully drafting the criteria for such an engagement e.g. whether the audit committee has followed a suitable code of practice set by a third party (i.e. not the auditor's own advice) which sets out the steps they should take.
	- Reviews and monitors the independence of the statutory auditor or firm and particularly the provision of additional services.	X				The self-review threat may be too great as it relates to the auditor forming a view as to whether the audit committee has correctly checked that the auditor themselves are independent. This is better done by explicit confirmation of the auditor's independence in the audit report, as required by ISA 700 (revised).

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
f.10	<u>Other Committees</u> - The Board should stipulate formal procedures for the work of the Board and its committees. *These procedures should be clear and well documented.*		X			
	- Depending on the specifics of the enterprise and the number of its members, the Board should form committees with sufficient expertise. *They should be aimed at increasing the efficiency of the Board's work and the handling of complex issues.*			X		
f.11	<u>Reporting</u>					
	- The Board should present a balanced and understandable assessment of the company's position and prospects (year-end).		X		X	For the company's position this is, in effect, the audit of a balance sheet. Assurance on prospects, i.e. as to the future, is unlikely to be possible or cost-effective.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
	- The quality of the reporting should be ensured in the form of policies, instructions for responsibility distribution.			X		See f.9 above.
	- The Board's responsibility should extend to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements (Interim).			X		The same level of auditor involvement should be possible for the interim as for the annual financial statements – see f.9 above.
	- In addition, the Board should establish formal and transparent arrangements for assuming responsibility for the preparation of the Board's work to ensure the quality of the company's financial reporting, for considering how they could apply the financial reporting and internal control system and for maintaining an appropriate relationship with the statutory auditors.			X		The same level of auditor involvement should be possible for the financial information as for the financial statements – see f.9 above. For other forms of reporting, it is less likely that auditor involvement is appropriate.

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
G	**Elements from the survey in addition to those addressed in the 2006 Directive amending the Fourth and Seventh Directives in relation to corporate governance statements**					
g.1	Present an activity report on Board and Board's committees meetings.		X			The auditor could factually check how many meetings of the Board and its committees took place and who attended on the basis of minutes.
g.2	Mention company's objectives.		X			
g.3	Disclose governance structures and policies and the process by which they are implemented.		X			

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
g.4	Present the financial and operating results of the company.				X	See f.11 above.
g.5	Define the foreseeable risk factors: operational risks, compliance with laws and regulations, and financial risks;		X	X	X	Any auditor, whether the statutory auditor or not, could check factually that the corporate governance statements' list of risks agrees to a risk register. In addition, the statutory auditor may be able to form an opinion in relation to the risk assessment for risks in relation to the financial reporting process as it is closely related to the work they will carry out under ISA 315; it is unlikely that it would be cost effective for another auditor to perform assurance work.
g.6	Information as to where any separate corporate governance statement has been made accessible to the shareholders.		X			

FEE

Reference to Table 2	Principles[28]	No Auditor's involvement	Factual Finding	Limited Assurance	Reasonable assurance	Comments
g.7	Statement as to how the listed company has applied the principles of the code, in a manner that would enable shareholders to evaluate how the principles have been applied.		X			The auditor can factually check that the statement exists. However, they could not form an opinion as to its accuracy without forming an opinion on each provision of the code and whether management had complied with it or not.
g.8	Disclose related-party transactions.				X	Assurance work is already carried out under ISA 550 in forming an opinion on the financial statements as these require disclosure by both the Fourth and Seventh Directives and by IAS 24. For this reason, it is unlikely to be cost-effective for another auditor to carry out this work.
g.9	Mention conflicts of interest: personal interest of the directors and the business interest of the company itself.		X			The auditor could factually check that the corporate governance statement contains the entries in a register of interests. It is unlikely to be cost effective for the auditor to form an opinion as to whether such an interest gives rise to an actual or perceived conflict.

FEE

7. Assurance Report on Corporate Governance Statement

7.1. Reporting the auditor's involvement within the audit report

As noted in Chapter 5, there is no specific IAASB standard for reporting on corporate governance statements. Chapter 5 explains FEE's views as to the different types of work that an auditor could possibly do and some of the potential issues in applying existing IAASB standards to such statements.

Under EU law, the auditor must issue a report on at least some aspects of the corporate governance statement. Article 46a of the 2006 Directive amending the Fourth and Seventh Directives imposes different responsibilities upon auditors depending on how the corporate governance statement is issued:

- When the corporate governance statement is included in the annual report (management report), the auditors must, as a minimum, report their opinion as to whether the annual report (management report) containing the corporate governance statement is consistent with the financial statements;

- When the corporate governance statement is in a separate report outside the annual report (management report), the minimum level of auditor involvement is to report an opinion as to consistency of the statement regarding certain elements with the financial statements, and to check whether certain other elements have been produced.

Auditors' work on these matters may be reported within the statutory audit report as it is work which, by law, they must carry out. Nevertheless, in France for instance, the law requires the opinion on the consistency of the description of the main features of the internal control and risk management system on the financial reporting process to be reported on in a separate report attached to the statutory audit report on the financial statements.

7.2. Reporting the auditor's involvement within the auditor's report on the annual financial statements

7.2.1. Audit report where the corporate governance statement is included within the annual report

ISA 700 (revised) is the International Standard on Auditing relating to the auditor's report on the annual financial statements[29].

Both the currently applicable version of this standard and the redrafted version prepared as part of the 'clarity' project provide for a separate second section in the audit report dealing with other matters on which the auditor is required to report by law and/or regulation. The work required by Article 51 and, where applicable, Article 46a(2), of the Fourth Directive would fall into this category.

[29] The same approach is taken under ISA 700 (revised and redrafted), the clarified version of ISA 700.

For example, where the corporate governance statement is included within the annual report (management report), the following paragraph could be added to an audit report.

> *Report on other legal and regulatory requirements*
>
> Management are required by [refer to law] to prepare an Annual Report (Management Report), which includes a Corporate Governance Statement. In addition to our responsibility to report on the financial statements described above, we are required by [refer to law] to report to you whether the Annual Report is consistent with the audited financial statements. Other than performing this consistency check, we are not required to, nor did we, perform any additional work to verify the information contained within the Corporate Governance Statement.
>
> In our opinion, the Annual Report (including the Corporate Governance Statement) is consistent with the financial statements.

ISA 700 (revised) does not indicate whether such a paragraph needs also to comply with the requirements of ISAE 3000 (for assurance conclusions) and/or ISRS 4400 (factual findings). FEE believes that, where the corporate governance statement is required by law or regulation and this engagement is carried out in accordance with national standards, reference to the law or regulation requiring preparation of the statement and to the law and applicable national standards setting out the related auditor reporting requirements are sufficient to report on the corporate governance statement when combined with the audit report on the financial statements.

7.2.2. Audit report when the corporate governance statement is presented separately from the annual report

A similar approach to that set out above could be used when the corporate governance statement is presented separately from the annual report (management report). The matter can still be dealt with in the auditor's report because that report is included in the same booklet or "glossy document" as both the corporate governance statement and the financial statements. For example:

> *Report on other legal and regulatory requirements*
>
> Management are required by [refer to law] to prepare a Corporate Governance Statement and Annual Report. In addition to our responsibility to report on the financial statements described above, we are required by [refer to law] to report to you whether:
>
> - The Annual Report; and
> - The sections of the Corporate Governance Statement dealing with the description of the main features of the internal control and risk management systems relating to the financial reporting process and with information required by [refer to law enacting relevant portions of the Takeover Bids Directive]
>
> are consistent with the audited financial statements. We are also required to check whether other information required by [refer to law describing the content of the corporate governance statement] has been produced. Other than performing these

checks, we are not required to, nor did we, perform any additional work to verify the information contained within the Corporate Governance Statement.

In our opinion, the Annual Report and the sections of the Corporate Governance Statement dealing with internal control and risk management systems relating to financial reporting processes and with information required by the [law enacting relevant portions of Takeover Bids Directive] are consistent with the financial statements.

The information required by [refer to law describing the content of the corporate governance statement] has been produced.

7.2.3. Assurance report required on other elements of the corporate governance statement

A similar approach could be adopted in respect of a mandatory limited or reasonable assurance engagement required by law or regulation to be performed by the statutory auditor on other elements of the corporate governance statement (whether those required by the Directive, national codes or laws):

Report on other legal and regulatory requirements

Management are required by [refer to law] to prepare an Annual Report (Management Report), which includes a Corporate Governance Statement. In addition to our responsibility to report on the financial statements described above, we are required by [refer to law] to:

- Report to you whether the Annual Report is consistent with the audited financial statements;
- Carry out limited assurance procedures on the elements of the corporate governance statement required by [refer to law]. Our work consists of analytical procedures and enquiries of management but does not normally include checking information back to source documentation.

Other than performing the consistency check and limited assurance procedures described above, we are not required to, nor did we, perform any other work to verify the information contained within the Corporate Governance Statement.

In our opinion:

- The Annual Report (including the Corporate Governance Statement) is consistent with the financial statements; and
- Based on the limited assurance procedures performed, we are not aware of anything which indicates that the elements of the corporate governance statement specified in [refer to law] are materially misstated.

Not all EU Member States have currently adopted ISA 700 (revised) and the European Commission has not yet concluded whether, if the clarity ISAs are adopted for use in the EU, ISA 700 (redrafted) will be adopted or a separate European Union audit report will be adopted under Article 26 of the Statutory Audit Directive. For example, in many Member States, the existing duty to report on the consistency of the annual report is dealt with in the body of the audit report on the financial statements. This could be achieved by adding the first paragraph of the examples above to the "Auditor's Responsibility" section of the report, and adding the second paragraph to the "Opinion" section.

7.2.4. Separate auditor's report or dual-dated audit report

In some countries, it is possible that the corporate governance statement may be approved at a different date than the financial statements. For example, the audit committee may be empowered to approve the financial statements but the Board as a whole must approve the corporate governance statement. This could be dealt with by either reporting the auditor's involvement in a separate report or by 'dual-dating' of the audit report. For example, the report could be signed as follows:

[Name of auditor] for and on behalf of [name of firm] [date of opinion on financial statements] except in respect of our work on the corporate governance statement, as to which the date is [date of conclusion on corporate governance statement]

7.3. Reporting the auditor's involvement in a separate report

In Chapter 6, FEE outlines a view of the possible further levels of reporting that an auditor could provide in relation to the various elements of a corporate governance statement regardless of whether or not it is included in the annual report. The commentary below deals with the ways in which an auditor could report their findings and opinions in areas that go beyond those required by law and regulation.

It is possible that an auditor could report at one level on some elements, at another level on other elements, and not at all on the remaining content. In drafting their report, the auditor will want to:

- Explain in the 'Auditor's Responsibilities' what level of work the auditor has performed on which elements of the corporate governance statement;

- Set out in the 'Opinion' or 'Conclusion', the result of the auditor's work and/or their opinion, based on the work he or she has performed.

An illustrative example of such a report is set out below. Whilst the report refers to the 'auditor', it could equally be adapted for use by another independent and suitably qualified practitioner than the statutory auditor.

The reports include reporting at each of the levels set out in Chapter 5. It covers all possible levels of auditor involvement. In practice, it is unlikely that work will be carried out at all of these levels so the reporting will be considerably simpler in practice.

Independent Assurance report To [APPROPRIATE ADDRESSEE]

We have performed [assurance work / the work set out below] on the corporate governance statement of [NAME OF COMPANY] for the year ended [Date].

The work carried out was:

- [reasonable level assurance work as to whether the elements identified with an A were properly prepared in accordance with [describe Corporate Governance Code or Law];
- [limited level assurance work as to whether the elements identified with a B were properly prepared in accordance with [describe Corporate Governance Code or Law];
- [checking whether [describe factual checks performed]].

Responsibilities of [board of directors/management board/individual] for the corporate governance statement

[The Board of Directors/Management Board/President of the Company] are/is responsible for the preparation and presentation of the corporate governance statement in accordance with [specify Corporate Governance Code or Law].

Responsibilities of auditors for the corporate governance statement

Our responsibility is to carry out the work set out below and report to you our [opinions][and][findings].

[Assurance] work performed

[To be included for assurance work only:

We planned and performed our work in accordance with International Standard on Assurance Engagements ISAE 3000 in order to obtain [reasonable assurance that the elements of the Corporate Governance Statement identified with an A were prepared in accordance with the provisions of [specify Code/Law]][and][limited assurance that the elements of the Corporate Governance Statement identified with a B were prepared in accordance with the provisions of [specify Code/Law]].

[Describe assurance procedures carried out in more detail e.g. Our work consisted of making enquiries of management and those charged with governance, reviewing minutes of meetings of the Board and its committees [and testing the operation of the procedures described in...][30] [The evidence-gathering procedures for a limited

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30 For limited and reasonable assurance the more detailed testing performed is normally described.

assurance engagement are more limited than those for a reasonable assurance engagement as we do not test…, and therefore less assurance is obtained than in a reasonable assurance engagement.][31]]

[To be included for factual findings:

We check {describe factual checks carried out}.]

[*Unless the entire Corporate Governance Statement has been subjected to assurance procedures:* [For the section[s] of the Corporate Governance Statement not marked with an [A][or][B],][32] we have not carried out assurance work [on the Corporate Governance Statement][33] and accordingly do not give any assurance as to the validity, accuracy and completeness of the information provided.]

[Opinion[s] [and[[Conclusions] on the corporate governance statement

In our opinion:

- [the elements of the Corporate Governance Statement identified with an A have been prepared, in all material respects, in accordance with the requirements of [specify Code/Law].
- [based on the limited assurance work described above, nothing has come to our attention that causes us to believe that the elements of the Corporate Governance Statement identified with a B have not been prepared, in all material respects, in accordance with the requirements of [specify Code/Law].

[Include factual findings]

[Auditor's signature]

[Date of the report]

[Auditor's address]

31 For limited assurance it is normal to make clear the limitations on the nature, timing and extent of procedures e.g. that whilst the auditor may have agreed the corporate governance statement back to board procedures, they did not attend all of the board meetings to check that those procedures were in fact operated.

32 To be included if assurance work has been carried out on some elements of the statement.

33 To be included if no assurance work has been carried out on any elements of the statement.

APPENDIX

Extract from Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings

Article 46a of the Fourth Directive as amended by the 2006 Directive:

1. "A company whose securities are admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments shall include a corporate governance statement in its annual report. That statement shall be included as a specific section of the annual report and shall contain at least the following information:
   a. a reference to :
      i. the corporate governance code to which the company is subject, and/or
      ii. the corporate governance code which the company may have voluntarily decided to apply, and/or
      iii. all relevant information about the corporate governance practices applied beyond the requirements under national law.

      Where points (i) and (ii) apply, the company shall also indicate where the relevant texts are publicly available; where point (iii) applies, the company shall make its corporate governance practices publicly available.

   b. to the extent to which a company, in accordance with national law, departs from a corporate governance code referred to under points (a)(i) or (ii), an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so. Where the company has decided not to apply any provisions of a corporate governance code referred to under points (a)(i) or (ii), it shall explain its reasons for doing so;

   c. a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process;

   d. the information required by Article 10(1), points (c), (d), (f), (h) and (i) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on take-over bids, where the company is subject to that Directive;

   e. unless the information is already fully provided for in national laws or regulations, the operation of the shareholder meeting and its key powers and a description of shareholders' rights and how they can be exercised;

f. The composition and operation of the administrative, management and supervisory bodies and their committees.

2. Member States may permit the information required by this Article to be set out in a separate report published together with the annual report in the manner set out in Article 47 or by means of a reference in the annual report where such document is publicly available on the company's website. In the event of a separate report the corporate governance statement may contain a reference to the annual report where the information required in paragraph 1, point (d) is made available. Article 51(1), second subparagraph shall apply to the provisions of paragraph 1, points (c) and (d) of this Article. For the remaining information, the statutory auditor shall check that the corporate governance statement has been produced.

3. Member States may exempt companies which have only issued securities other than shares admitted to trading on a regulated market, within the meaning of Article 4(1), point (14) of Directive 2004/39/EC, from the application of the provisions of paragraph 1, points (a), (b), (e), and (f), unless such companies have issued shares which are traded in a multilateral trading facility, within the meaning of Article 4(1), point (15) of Directive 2004/39/EC".

Article 50b of the Fourth Directive:

"Member States shall ensure that the members of the administrative, management and supervisory bodies of the company have collectively the duty to ensure that the annual accounts, the annual report and, when provided separately, the corporate governance statement to be provided pursuant to Article 46a are drawn up and published in accordance with the requirements of this Directive and, where applicable, in accordance with the international accounting standards as adopted in accordance with Regulation (EC) No 1606/2002. Such bodies shall act within the competences assigned to them by national law".

Article 36(2) of the Seventh Directive:

"(f) a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts, where an undertaking has its securities admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments. In the event that the consolidated annual report and the annual report are presented as a single report, this information must be included in the section of the report containing the corporate governance statement as provided for by Article 46a of the Directive 78/660/EEC.

If a Member State permits the information required by paragraph 1 of Article 46a of Directive 78/660/EEC to be set out in a separate report published together with the annual report in the manner prescribed by Article 47 of that Directive, the information provided under the first subparagraph shall form part of that separate report. Article 37(1), second subparagraph of this Directive shall apply".

Article 36a of the Seventh Directive:

"Member States shall ensure that the members of the administrative, management and supervisory bodies of undertakings drawing up the consolidated accounts and the consolidated annual report have collectively the duty to ensure that the consolidated accounts, the consolidated annual report and, when provided separately, the corporate governance statement to be provided pursuant to Article 46a of Directive 78/660/EEC are drawn up and published in accordance with the requirements of this Directive and, where applicable, in accordance with the international accounting standards adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. Such bodies shall act within the competences assigned to them by national law."

Extract from Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings

Article 51 (1) second subparagraph of the Fourth Directives:

"The statutory auditors shall also express an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same financial year."

Article 37 (1) second subparagraph of the Seventh Directive:

"The person or persons responsible for auditing the consolidated accounts (hereinafter: the statutory auditors) shall also express an opinion concerning the consistency or otherwise of the consolidated annual report with the consolidated accounts for the same financial year."

Extract from Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

Article 41

Audit committee

1. Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the

audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.

In public-interest entities which meet the criteria of Article 2(1), point (f) of Directive 2003/71/EC, Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee.

2. Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, *inter alia:*

(a) monitor the financial reporting process;
(b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
(c) monitor the statutory audit of the annual and consolidated accounts;
(d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

3. In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee.

4. The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

5. Member States may allow or decide that the provisions laid down in paragraphs 1 to 4 shall not apply to any public interest entity that has a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out these functions and how it is composed.

6. Member States may exempt from the obligation to have an audit committee:

(a) any public-interest entity which is a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC if the entity complies with the requirements in paragraphs 1 to 4 of this Article at group level;
(b) any public-interest entity which is a collective investment undertaking as defined in Article 1(2) of Directive 85/611/EEC. Member States may also exempt public-interest entities the sole object of which is the collective investment of capital provided by the public, which operate on the principle of risk spreading and which do not seek to take legal or management control over any of the issuers of its underlying investments, provided that those collective investment undertakings are authorised and subject to supervision by competent authorities and that they have a depositary exercising functions equivalent to those under Directive 85/611/EEC;
(c) any public-interest entity the sole business of which is to act as issuer of asset-backed securities as defined in Article 2(5) of Commission Regulation (EC) No 809/

2004. In such instances, the Member State shall require the entity to explain to the public the reasons for which it considers it not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee.

(d) any credit institution within the meaning of Article 1(1) of Directive 2000/12/EC whose shares are not admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC and which has, in a continuous or repeated manner, issued only debt securities, provided that the total nominal amount of all such debt securities remains below EUR 100,000,000 and that it has not published a prospectus under Directive 2003/71/EC.

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