FEE FORUM ON RISK MANAGEMENT AND INTERNAL CONTROL IN THE EU

ROYAL WINDSOR HOTEL, BRUSSELS
TUESDAY 25 OCTOBER 2005

134 participants registered for the FEE event and 101 attended the event. Slides and presentations are available on the FEE website.

In his keynote speech, EC Director General Dr. A. Schaub focused on the proposed Directive amending the 4th and 7th Company Law Directives. The EU Council agreed on a general approach in June 2005. A decision in the European Parliament is expected by the end of the year. The scope of the Directive is broader than listed companies and the Commission agreed to substantially increase the thresholds for small and medium companies. Concerning internal control, Dr. Schaub emphasised the flexible approach proposed concerning the corporate governance statement (description of the main features) and the role of the audit committee under the revised 8th Directive in monitoring the effectiveness of the company's internal controls.

Mr. R. Hodgkinson, Chairman of the FEE Working Group on Risk Management and Internal Control summarised the FEE discussion paper comparing the approaches in the EU proposed Directives, Section 404 of the Sarbanes-Oxley Act and Dutch, French, Swedish and UK requirements. These national models reveal a wide variety of requirements not only concerning the levels of disclosure (the Dutch system being the most extensive) but also concerning the management of risks.

Panel 1: *Where is the demand for internal control and risk management coming from?*

Mr. J. P. Servais, speaking as a regulator said that there can be differences in regulators' requirements when they are just dealing with securities markets or when they are carrying out prudential control of insurance companies and financial institutions. He agreed with the FEE paper that it is preferable to work with principle-based regulations and not with detailed rules. The objective should be to demonstrate that directors are accountable to shareholders and not to please regulators. He criticised the way audit committees have been legislated because it gives the wrong impression that the purpose of audit committees is mainly to monitor external auditors' work and independence, whereas they also have to look at the internal control system. He emphasised the importance of timeliness and cost/benefit analysis in disclosure.

Mr. R. von Rosen said that investors want to be sure they will not lose money. Considering the asymmetry of information between shareholders and managers some information requirements must exist to prevent managers from acting at the expense of shareholders. Companies whose risk management system is found to be well-organised may enjoy strongly decreasing funding costs. On the other hand, companies with worse internal controls may be confronted with increasing costs of capital. However there is a natural limit to reporting.

Mr. von Rosen criticised legislation where self-regulatory solutions exist. The market should define the right level of information required. He disagreed with the wish in the EU as in the US to take superfluous initiatives on regulating corporate governance. Audit committees are useful instruments but why is it necessary to define who can be a member. Over-protection of investors could kill the markets. Answering a question he said that it is wrong to punish all companies for the crimes of a few black sheep.

Mr. G. Dallas said that investors are more interested in knowing how management is managing the risks of the business than in financial reporting on past events. Assessment of risk management and also transparency of the governance system are increasingly becoming important factors in rating assessments.

Mr. Dallas observed that the narrow approach of the US regulatory model does not cover strategic and operational control. He also believes it wrong to focus extensively on compliance with financial controls. Understanding the exposure to risks must be considered case by case. Mr. Dallas believed that there is a demand for better control and information on how companies approach risk management in terms of policies, infrastructure and methodologies. Delivering assurance on the effectiveness of controls is more complicated. He observed that Sarbanes Oxley has proven useful in specific companies by stimulating needed improvements in internal control systems. But he observed that for many other companies the incremental costs of compliance may exceed related benefits. He also noted that it would be naive to believe that risks can be eliminated by regulatory fiat, and market participants should still scrutinize companies on a individual basis to assess whether governance is a positive, negative or neutral risk factor.

At the end of the Panel chair Mr. A. Popham drew the following conclusions:

- There is a demand for raising the bar on risk management.
- The market must have a leading role; we need to work on building trust between companies and investors.
- Description is preferable to compliance with a set of rules.
- Audit committees are important, not just for auditors.
- Disclosure of risks is useful but the company needs to continue facing risks.
- There is no demand for assurance on effectiveness of internal control systems.

Panel 2: *US requirements to report on internal control*

Mr. A. Bailey compared the benefits and costs of the US system. He recognised the risk of over-regulating the 98% of managers who are doing their jobs properly. The cost of compliance with the Sarbanes-Oxley Act Section 404 is high but the way it was implemented exceeded what was originally expected, in particular concerning the scope of testing. Mr. Bailey also indicated that many registrants seem to have tested at a rather detailed level of control. The level of detail identified and tested appears to have been more extensive than 404 envisioned and thus may be part of the explanation as to the higher than expected costs.

Mr. Bailey said that there are difficulties and, some believe, inconsistencies in applying a number of concepts including the probability and materiality concepts. He agreed that the probability and materiality concepts included in 404 and AS 2 are important drivers of the extent and cost of testing. He also recognised an unintended consequence of the Sarbanes-Oxley Act Section 404 which was a reduction of communication between the board and auditors. He indicated that both the SEC and PCAOB have clarified the communications issues and hope that this unintended consequence has been remediated. Mr. Bailey also discussed the project to develop COSO guidance for SMEs which identified 26 principles underlying the initial COSO model.

Mr. J. Ripley explained that in a large company such as Unilever, operational models change rapidly. Few risks are correlated between operational units. The US law is applied to the company even if only 24% of the shares are owned in the US. He gave details on what Unilever did to comply and what they learned from the exercise. The risks/rewards balance is different for managers and entrepreneurs. Having more control and more protection can have an adverse effect; you may be inclined to take more risks because you have the wrong impression that you will not damage yourself.

Mr. Ripley developed two messages:

- Intervention in a complex environment may have unintended consequences: disclosure of weaknesses would affect managers' positions, the cost of finance and competition from unregulated competitors.
- The costs of the Sarbanes-Oxley Act are clear but the rewards are not.

In the exchange of views, Mr. Montagnon said that there is nothing wrong in allowing shareholders to dismiss directors; this could help to improve the situation in the US. Mr. Bailey answering a question acknowledged that the PCAOB has room for reviewing AS2 without changing the Sarbanes-Oxley Act. He noted that it might have been possible to do a better implementation job with more time, but the atmosphere of scandals at the time was a real issue and did not allow for a staged roll-in of 404 or AS2.

Panel 3: *Developments in certain European countries*

Mr. P. Marteau emphasised the following aspects concerning regulations in France:

- We need a framework for internal control.
- Originally, the French system had a very wide scope but it was brought back to a description of the internal control system in listed companies in 2005.

- The French law should contribute to improving overall efficiency by requiring companies to have a comprehensive description of procedures and a first degree of assessment. However no rule will make fraud impossible.
- A benefit of the new law is that it improves the role of CFOs towards directors of operations.
- Disclosing weaknesses is a bad idea; information on aspects to be improved is acceptable.
- Controls between internal and external audit must be developed.

Mr. Gratama van Andel commented on the situation in the Netherlands. The background is the Tabaksblat Code (2003) which establishes best practice provisions. Paragraph II 1.4 is very wide in scope, it requires management to declare in its annual report that the internal risk management and control systems are adequate and effective and provide a clear substantiation of this. The cost of implementation was huge; for the company DSM more than 13 million euros. The problems with delivering assurance are caused by the wideness of the scope. Management's declaration does not go further than providing reasonable assurance that the system is effective.

Mr. A. Malmeby reviewed the new Swedish corporate governance code which requires the board to prepare an annual report on how internal controls over financial reporting are organised and function. The report must be reviewed by auditors. The reporting guidance for the Boards´ has recently been issued and has now translated into English. Mr Malmeby commented on the guidance and the principles behind the work. The Swedish system does not prescribe the use of a specific framework for internal control. If an international established framework is used, that should be mentioned in the report by the Board. The guidance makes use of COSO and its five components. It is principle-based and uses a top down rather than a bottom up approach. It is designed in order to function in an international environment. Concerning assurance implications, Mr. Malmeby said that an initial approach was tested in a recent public consultation. The initial approach was based on limited work by the auditors and was rejected by both investors and auditors. The latter due to concerns regarding the potential expectation gap and the former due to lack of an opinion from the auditor. Based on the public consultation, work is currently under way from the Swedish Institute (FAR) concerning a limited assurance engagement.

Mr. D. Flint agreed with the previous speakers that understanding risk does not mean that a manager should avoid taking risks. He commented on the work of the Turnbull Review Group which made a small number of amendments to the Turnbull guidance on internal control. There was strong support for retaining the principles-based approach; the relative lack of prescription was seen as a strength. There was unanimous support for the guidance continuing to cover all controls, not just financial reporting controls. Investors want to know more about managers' attitudes to risk. If significant failings or weaknesses in internal control have been identified, boards should confirm that necessary actions have been or are being taken to remedy them. There was no support for reporting on effectiveness by companies or external auditors.

In conclusion Mr. Flint said that application of the guidance improves risk management and internal control. Boards need to ensure that application of the guidance takes account of changing circumstances in the business and boards should take the opportunity to communicate better with investors.

In the questions and answers session Mr. Flint agreed with Mr. Bailey that material weaknesses had been disclosed as a result of Section 404. However he added that the danger of too many disclosures is that people could become immune to disclosures. A focus on non-compliance becomes a problem when boards spend more time on reporting issues than on discussing strategy.

Mr. J. Winter wrapped up this session and suggested that we benefit at least as much from questions as from answers. He also said that very often companies behave similarly and work towards the same solution even if the environment is different because the board tries to work in the best interests of the shareholders'. He also observed that most speakers do not favour limiting internal control reporting to financial reporting controls.

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Mr P Ashton reported on the work of the IAASB. The standard setters are not addressing internal control reporting directly but ISA 315 requires the auditor to disclose material weaknesses to the audit committee. ISA 240 and 720 should also be taken into consideration. Answering a question of Mr. D. Devlin, Mr. Ashton recognised that the IAASB has not limited the problem of financial reporting issues to listed companies only.

Mr. R. Hodgkinson then reported on comments received on the FEE discussion paper. No respondent would support a Sarbanes-Oxley Section 404 for Europe. No commentator would recommend a EU Framework. There is agreement on the idea that a company should keep proper accounting records and that the law should make it mandatory. The FEE regulatory principles and the principles of disclosure were broadly supported. There are divided views on the need to focus on listed companies and on assurance issues.

President D. Devlin summarised the discussions emphasising the following ideas:

- The European Commission will not follow a prescriptive approach, which is welcomed.
- The wide approach which is not only focusing on financial reporting controls is widely supported.
- It is right to carry out a cost/benefit analysis and to take care about unintended consequences of prescriptive regulations.
- There is no evidence of demand for a report on effectiveness in Europe.
- The US authorities have the possibility to revisit AS2 and to amend the prescriptive approach with the existing legal framework.
- Legislation on risk management cannot ask managers to refrain from accepting risks; it will also not stop bad guys from committing crimes.

- Scandals encourage debates but if this debate is closed permanently it will blow up again on the first occasion.
- The issue is fertile for convergence.
- Implementing the proposed Directive revising the 4th and 7th Directives is a national issue but it will be important to look at what solutions will be selected by Member States. Some of them already have very demanding systems (for instance in the Netherlands), others have no requirements as yet.