



International Federation of Accountants

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Mr. David Devlin
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By Email: secretariat@fee.be

Dear David

FEE Discussion Paper – Risk Management and Internal Control in the EU

INTRODUCTION

The Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC) welcomes the opportunity to comment on the Fédération des Experts Comptables Européens (FEE) Discussion Paper on *Risk Management and Internal Control in the EU*. We are also appreciative of your granting us an extension to the deadline for comment to August 31, 2005.

IFAC considers corporate governance, risk management, and internal control to be highly topical areas and ones which will benefit from the discourse stimulated by this paper. We are, therefore, wholly supportive of FEE's decision publish its views.

This submission has been prepared by IFAC staff with assistance from members of the PAIB Committee who have an interest and expertise in corporate governance, risk management and internal control. In compiling the submission we have noted that John Kellas, Chairman of the International Auditing and Assurance Standards Board (IAASB), in a letter dated July 28, has already responded on behalf of his board's Steering Committee. Accordingly, we have decided to avoid commenting on matters of external assurance.

This submission is organized as follows. First, our general observations are presented below. Second, responses to the specific questions posed in the discussion paper are outlined in the Appendix.

GENERAL COMMENTS

IFAC endorses many of the views expressed by FEE, in particular its stance that any move to introduce formal requirements should be based on evidence of value (Section 1.1 and 1.3), a commitment to a learning approach rooted in the search for best practice (Section 1.3), support for a principles-based approach (Section 1.3) that can apply sensibly to SMEs as well as large listed companies (Section 3.3), and a preference for pursuing global rather than European solutions (Section 4.2).

Most significantly IFAC supports FEE's conclusion that regulation along the lines of the Sarbanes-Oxley Act is inappropriate. Eventually, demonstrating compliance with requirements to comply will become self-defeating, as well as onerous, since it naturally encourages a process- rather than outcome-focused way of dealing with risk management and internal control. While there is a consistent outcome requirement – that appropriate stakeholders should receive assurance from management that an entity is achieving its objectives, complying with the law and generally under control – the context in which it has to be delivered can vary widely: prescribing a common process is therefore unlikely to cover all eventualities, and will tend to require continual further elaboration.

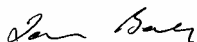
In order to facilitate international convergence and ensure the public interest is served IFAC believes the immediate aim should be the development of a common set of principles that apply equally well to any entity irrespective of its type and size and the sector and jurisdiction in which it operates. However, regulatory requirements and the development of application guidance supporting best practice should, for both political and practical reasons, initially focus on publicly accountable entities. Meanwhile, other entities, if they are not to be regulated, should at least be exhorted. One needs to avoid doing, saying or encouraging anything that might reinforce a perception that good governance, risk management and internal control are important only within listed entities.

CONCLUDING COMMENTS

IFAC welcomes the initiatives that FEE has undertaken to address the issue of risk management and internal control. We hope that this response proves constructive and look forward to providing FEE with further assistance in this vital area in the future.

Please do not hesitate to contact me should you wish to discuss any of the matters raised in this submission.

Yours sincerely,



Ian Ball,
Chief Executive, IFAC

1. Do you agree with FEE that there is a need to promote discussion and evidence gathering to encourage coordination and convergence of the development of risk management and internal control at EU level? If not, please explain. (Section 2.4)

Yes. It is critical that there is international debate as to what risk management and internal control is and how it may be improved. This paper will help foster a shared understanding of the issues and help in the development of a suitable (principles-based) framework for tackling it. We must not forget that, in an increasingly global business environment, what is practiced elsewhere will impact the domestic scene, a fact amply demonstrated by the ramifications of Section 404. In addition, individual nations stand to gain from the experience of others. The ability to understand and compare standards and practices across different markets is an important tool for both improving standards and guidance generally and facilitating international convergence. Finally, it is vital that an appropriate balance be struck between conformance and performance and that an entity's actual risk exposure matches up with that desired by the entity and its key stakeholders.

2. Do you consider it appropriate for public policy on risk management and internal control in the EU to focus on listed entities and the needs of their shareholders? Alternatively, do you think that there is a pressing need to deal with issues relevant to a wider range of entities and stakeholders? If so, please explain. (Section 2.4)

IFAC would encourage the development of principles underpinning any best practice guidance to be developed with all entities in mind – that is listed and unlisted, small and large, operating in the not for profit, public and private sectors – and all stakeholders. IFAC feels that an all inclusive approach will best serve the public interest as well as facilitate a quicker and smoother process towards sustainable international convergence in the area of risk management and internal control. All too often in the sphere of financial reporting and corporate governance SMEs and public sector entities get neglected and are left to pick and choose from ill-fitting requirements and guidance that were developed with only larger listed companies in mind. It is also important to acknowledge that one must not encourage an approach that might reinforce a perception that good governance, risk management and internal control are only important within listed entities.

Collectively, unlisted entities including small and medium sized entities (SMEs), not for profit and public sector entities, account for a large proportion of gross domestic product and employment and in turn make a significant contribution towards economic growth and stability as well as social welfare. Public sector entities, especially those that are large users of public resources, make a vital contribution to the wellbeing, success and prosperity of the wider community and, as such, they need to ensure the proper and effective use and stewardship of the funds and other assets with which they are entrusted. In the not-for profit and public sectors, stakeholders subscribe current operating funding as well as capital and accordingly should be accountable to them in this respect.

While suggesting that the focus be extended to all entities it should also be emphasized that any framework must not be too broad and generic as to be ineffective and meaningless. In particular, the principles should aim to be pragmatic and include elements that are measurable. IFAC does not underestimate the difficulty of arriving at an appropriate balance.

Once a common set of principles are in place the focus should then turn to developing more detailed application guidance and the appropriate regulatory requirements. Such best practice guidance and corresponding regulatory requirements will vary according to the type and size of entity and the jurisdiction and sector in which they operate. At this point IFAC believes that, for both political and practical reasons, the initial focus should be on listed entities. IFAC, however, feels that this initial focus should extend to all publicly accountable entities (as per the definition¹ recently proposed by the International Accounting Standards Board (IASB) as part of its project on accounting standards for SMEs) not just listed entities.

3. Do you agree with FEE that the case for introducing any regulation related to risk management and internal control should have regard to: the business case for risk management; the advantages of principles-based requirements; the distinctive features of listed companies; the primacy of those charged with governance; and reasonable liability? If not, please provide details.(Section 3.6)

*Yes **except** that the overriding principles underpinning the case for any regulation relating to risk management and internal control should apply to all entities as explained in our response to question 2. It is important, however, that legislation for non-publicly accountable entities should be kept to an appropriate minimum.*

4. Are there overriding principles additional to those identified by FEE in Sections 3.1 to 3.5 that are relevant to risk management and internal control? If so, please explain. (Section 3.6)

Yes. The burgeoning interest in corporate social responsibility and sustainability reflects a growing belief that entities should be accountable to all of their stakeholders, be they equity shareholders, creditors, employees, local community and so on. This dimension of corporate governance is touched on in Part V of the OECD Principles, 'The Role of Stakeholders in Corporate Governance'. Therefore, one could capture this wider aspect of accountability through the inclusion of a principle titled 'the corporate responsibility case for risk management'.

The paper rightly recognizes that business is about getting profit through taking risks and, as a result, replaces risk-aversion with managing risk within a considered view of the appetite for risk. In this way the paper portrays risk management and internal control as having both a conformance and performance dimension.

¹ See pages 4 and 5 of http://www.iasb.org/uploaded_files/documents/16_33_0506SMETopicSummary.pdf

If a sector-neutral approach were to be adopted, as we suggest in the response to question 2, then some of the principles may need adapting. For example, the first sentence of Section 3.1 positions risk management and internal control as helping a business “define and achieve its objectives”. The first half of this is true in only a limited way, because such organizations are rarely entirely free to determine their objectives, while the second half remains vital. Generally the reward for risk taking is not profit, although even within the public sector taking responsible risks remains important to achieving the most from available resources. In addition, the first paragraph of Section 3.5 does not provide a precise fit with the public sector though remains generally true.

5. Is the matrix for analysis presented in Figure 1 in Section 4.1 clear and useful? If not, please explain why not. (Section 4.4)

Yes. This matrix is unequivocally clear and useful. It provides a sound framework for discussion and is one of the strengths of this paper.

6. Is there any need to develop an EU framework for risk management and internal control? If so, how would you address the concerns about resources and benefits identified by FEE in Section 4.2? (Section 4.4)

No. There is little if any value to be had from developing yet another framework and IFAC applauds FEE for encouraging the pursuit of “global solutions”. The ones presently in existence apply equally well to the EU as they do the jurisdictions in which they originated. Moreover, IFAC believes that an EU framework could potentially be detrimental to the process of global convergence. As evidence of how an additional framework could impede the convergence process IFAC notes the difficulties currently faced by multi-national companies when having to comply with a number of frameworks. We do, however, recognize that some modifications to existing frameworks may be required to arrive at a common framework capable of accommodating the differences in governance structures that exist between different EU member states, such as unitary verses two-tier boards.

7. Do you agree with FEE’s disclosure principles for risk management and internal control set out in Section 4.3? If not, why not and are there additional factors that should be considered? (Section 4.4)

*Yes **except** that as we explain in the response to question 2 we would prefer the emphasis to be on stakeholders in general rather than just shareholders. While it is important to establish agreed principles for disclosure, and the principles stated here provide a good basis, we feel that the compliance and reporting aspects of risk management and internal control should not be overemphasized. Disclosure of what is happening is less important than actually knowing what is happening. This aspect of risk management and internal control - how one deals with unknown unknowns - is arguably the most difficult to accommodate. Even the best-run businesses will be vulnerable to something that nobody foresaw. Furthermore, perhaps the most important determinant of effective risk*

management and internal control is the culture and mindset of the entity as set by the top management. This is hard to accommodate effectively in reporting.

8. Do you agree with FEE's proposal that there should be a basic EU requirement for all companies to maintain accounting records that support information for published financial statements? If not, why not? (Section 5.6)

Yes if by 'all' one includes unlisted companies. IFAC would also encourage this requirement being extended to those not for profit and public sector entities that are required to publish financial information.

9. Do high-level criteria need to be developed to promote meaningful descriptions of internal control and risk management as envisaged by the proposal to amend the Fourth and Seventh Directives? If so, who should develop the criteria and if not, why not? (Section 5.6)

Yes. High-level criteria capable of application in any jurisdiction would be useful and encourage international convergence at both the EU and global level.

10. What role should regulatory requirements play in promoting improvement in risk management and internal control? (Section 5.6)

Regulatory requirements should seek to encourage global convergence of best practice. Regulators should focus on setting minimum requirements for publicly accountable entities that are built around a common set of principles and basic elements of best practice. These minimum requirements should have global application so as to minimize unnecessary effort dealing with differing regimes. Legislative backing should restrict itself to publicly accountable entities while governments may also encourage others to follow suit. Regulators should support efforts to establish evolving best practice by issuing non-mandatory application guidance. It is likely that this guidance will need to be tailored to different types of entity.

11. Do you agree with FEE's identification of the issues for consideration by listed companies and regulators set out in Section 5.5? Are there any other matters which should be dealt with?

Yes except that we would encourage the application to all companies not just listed entities as mentioned in our response to question 2. However, one might expect unlisted entities to evolve at a slower rate given that they are not subject to the same capital market pressures as their listed counterparts and the fact that political pressure falls most heavily on listed entities.

12. What views do you have on the issues for consideration discussed in Section 5.5? (Section 5.6)

Issues related to managing risks – the emphasis should be on managing risks so as to ensure the sustainability of the entity’s operations.

Issues related to disclosure of overall process and of management of specific risks - boilerplate disclosure needs to be avoided.

Issues related to disclosure of effectiveness conclusions – on the face of it there seems merit in effectiveness disclosure. Unfortunately, the task of meaningful disclosure does present significant challenges. The step-by-step, evolutionary approach suggested in the paper makes sense. In addition it is important that the views of stakeholders are obtained as to whether they see value in disclosing effectiveness conclusions and, if so, what type of information would prove useful.

13. Do you consider that the current financial statement audit provides adequate assurance to investors in respect of internal controls over financial reporting? Please explain your response. (Section 6.7)

Please refer to letter from John Kellas

14. Should new disclosures related to risk management and internal control be subject to external assurance? If so, why, and should this be as part of an integrated financial statement audit as in the United States? (Section 6.7)

Please refer to letter from John Kellas

15. What do you see as the principal priorities in the possible development of new forms of assurance related to risk management and internal control? (Section 6.7)

Please refer to letter from John Kellas

In addition, do you have any other comments on this discussion paper not covered by the specific questions reproduced above?

See general comments in body of cover letter and additional comments under each question.