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DISCUSSION PAPER
ON THE FINANCIAL REPORTING AND AUDITING ASPECTS OF CORPORATE GOVERNANCE

July 2003

CONTENTS

1 EXECUTIVE SUMMARY AND RECOMMENDATIONS

Key Messages and Recommendations of this Discussion Paper

SOME COMMON PRINCIPLES FOR NATIONAL CODES

- FEE supports the conclusions of the Jaap Winter Group and the Commission's Communication on Company Law and Corporate Governance that there is no need for a separate European Corporate Governance Code. However, in order to ensure adequate co-ordination, some principles and common benchmarks for national codes (soft law) of corporate governance should be set at European level, together with guidance on the "comply or explain" approach to corporate governance advocated in the Jaap Winter Group Report. The Commission's Communication confirms that a common approach should be adopted at EU level with respect to a few essential rules and adequate co-ordination of corporate governance codes should be ensured.

BALANCE OF POWER AT BOARD LEVEL

- All companies need able management but in any board system it is important to have an appropriate balance of power such that no single individual, or group, has unfettered control of the company. FEE therefore recommends that, at least for listed companies, in a unitary board, the roles of chairman and chief executive should be held by different people balanced by a strong independent non-executive element. In a two-tier structure, at least for listed companies, the management board should have further members in addition to the chief executive.

AUDIT COMMITTEE FUNCTION FOR ALL LISTED COMPANIES

- All listed companies should have an audit committee function discharged by non-executive directors or supervisory board members where, at a minimum, the majority of the committee's members are independent. The members of the audit committee should be appointed by the (supervisory) board. FEE recommends that under a unitary board system all listed companies should be obliged to have an audit committee. Under a two-tier board system all supervisory boards of listed companies above a certain company size should have audit committees. A company should indicate in its corporate governance statement when it has no audit committee and give the reasons why, and explain how the audit committee function has been discharged.

INDEPENDENCE: A KEY ATTRIBUTE

- Where the national law or codes require certain NEDs to be independent, the (supervisory) board, in its consideration of independence, should use a principles based approach to assess threats and safeguards to independence. Within this approach, fundamental principles, which must always be observed, are defined and any threats, which could impede observance of these principles, should be identified. Where threats exist, safeguards should be put in place to eliminate or reduce them to an acceptable level. If no appropriate safeguard can eliminate or reduce the risk to an acceptable level, the only safeguard consists in either refraining from participating in the decision making process or resigning. This principles based approach including guidance and restrictions, combined with prohibitions where appropriate, should give more satisfactory results than a lengthy set of detailed rules, the spirit of which can be circumvented.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

COMPREHENSIVE DISCLOSURE ON CORPORATE GOVERNANCE

- FEE agrees with the Winter Group and the Commission's Communication on Company Law and Corporate Governance that disclosure is a powerful tool to improve corporate governance. FEE therefore supports the recommendation to require companies to make a comprehensive corporate governance statement in their annual reports. Responsibility for such a statement should rest with the board, which in a two-tier system means both the management and the supervisory boards. There is a need for an agreed framework for corporate governance reporting setting out common principles on the form and content of such reports. While considerable progress has been made in identifying the core issues to be reported, little progress has been made in establishing the conceptual underpinning that any form of public reporting requires. FEE would be willing to work with other parties to develop such a conceptual framework.

AUDIT COMMITTEE RESPONSIBILITIES

- Full responsibility for the review of financial reporting and other related matters remains with the entire (supervisory) board. The audit committee undertakes certain tasks on behalf of the (supervisory) board.

- The audit committee's core responsibilities should include:

  - Reviewing financial reporting arrangements: including the review of the interim and annual financial statements, the other financial information published by the company, including related party disclosures, and internal control related to financial reporting to ensure overall balance and transparency;
  - Monitoring the relationship with the external auditor; and
  - Monitoring the work and resources of the internal audit function.

  In addition to its core functions, FEE recommends that responsibilities of the audit committee should include reviewing:

  - Wider aspects of internal control linked to the significant business risks faced by the company when not addressed by a separate specialised risk committee(s);
  - The company's policy and practice to aid the prevention and detection of fraud;
  - The company's policy and practice of corporate conduct and business ethics; and
  - Its policies for ensuring that the company complies with relevant regulatory and legal requirements.

LONG FORM REPORTING BY AUDITORS TO BOARDS

- Boards should explore the use of extended (usually referred to as "long form") reports to boards by the external auditors in combination with oral presentations and discussions allowing for more informal and in-depth exchange of views between the auditor and the audit committee or board.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

AUDITORS VIEW ON ACCOUNTING POLICIES AND JUDGEMENTS

- The external auditors should communicate to the audit committee the company's significant accounting policies and practices including, where appropriate, alternative accounting treatments and their assessment of the principal accounting judgements exercised.

PURCHASING POLICY FOR NON-AUDIT SERVICES

- The audit committee should establish – or, depending on the governance structure, at least formulate and recommend - its policy on purchasing non-audit services in line with any applicable legislation, bearing in mind also guidance and best practices; it should ensure that, whilst allowing sufficient flexibility to take account of new situations, the overall policy is adhered to and keep under review the external auditors' role and independence. Elements of such a purchasing policy may include:

  - Approval of a range of audit related and other services such as due diligence and taxation;
  - Delegation to management of an authority to purchase such services up to an agreed parameter;
  - Provision for specific approval for large or sensitive assignments; specifically, however, FEE believes that it is not appropriate for the audit committee to approve each individual contract for non-audit services; and
  - Provision for regular reporting to the audit committee by management.

  The audit committee's report that is included in the board's annual report to shareholders should set out its policy on non-audit services and explain its assessment that there are sufficient safeguards to ensure independence in relation to the provision of these non-audit services.

FEE WANTS TO HELP LEAD THE DEBATE ON CORPORATE GOVERNANCE IN EU

- FEE is pleased that corporate governance is now high on the European Commission's agenda as evidenced by the May Communication on Company Law and Corporate Governance. With this Discussion Paper FEE hopes to help lead the activities announced, and the debate triggered by the Action Plan described in the Commission's Communication, so far as it concerns financial reporting and auditing aspects of corporate governance.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

1.1 Context

RESTORING CONFIDENCE IN CAPITAL MARKETS

Interest in corporate governance has been growing in reaction to the role of accounting errors or fraud in the demise of a number of important companies. Many of the recent corporate failures could be attributed to a lack of integrity on the part of management where individuals were involved in aggressive accounting, earnings management or fraudulent financial reporting to manipulate share prices, borrowings and bonus plans. There is now a clear need to restore confidence in capital markets and elsewhere by enhancing corporate governance in order to provide financial information of the highest quality.

The purpose of this FEE discussion paper is to consider the role of sound corporate governance in financial reporting and auditing and make practical recommendations from the perspective of the European accountancy profession. Confidence in financial reporting, and in audit, is a key factor in ensuring confidence in capital markets. This paper aims to contribute to restoring this confidence by offering the accountancy profession's perspective as part of the ongoing debate. The paper also provides input to the Commission's invitation for comments in its Communication on Company Law and Corporate Governance[1]. The paper is expected to be of interest to all parties involved in the corporate governance debate including the Commission, enforcement bodies, the accountancy profession and executive and non-executive directors (mainly through company representative organisations).

CONTENTS AND SCOPE

The paper describes the elements of good corporate governance relevant to the process of financial reporting and auditing but does not attempt to cover every aspect of corporate governance. It highlights the importance of internal control and the pre-requisites for sound corporate governance including structures, relationships and behaviour. In particular it considers the fundamental relationships and obligations between company boards, auditors, shareholders and other stakeholders as key to an effective corporate governance system. FEE, as the representative body of the European accountancy profession, has a profound interest in these matters and has a unique contribution to make.

The paper focuses on publicly listed companies, but is also relevant to other entities, in particular to public interest entities. The paper does not address industry (sector) specific elements of corporate governance.

This paper applies both to unitary and two-tier systems. The term "board" has a different meaning under both systems. In a unitary system the term "board" means its members including executive and non-executive directors. In a two-tier system the term "board" is distinguished between the management board and supervisory board. Where the term "board" is used in this paper and has a different meaning, the terms will be specified in brackets where necessary.

[1] EC Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" (21 May 2003)

1.2 *Non-executive directors and the supervisory board*

BALANCE OF POWER AT BOARD LEVEL

All companies need able management but in any board system it is important to have an appropriate balance of power such that no single individual, or group, has unfettered control of the company. FEE therefore recommends, at least for listed companies, that in a unitary board, the roles of chairman and chief executive should be held by different people and that there should be at least two executive directors balanced by a strong independent non-executive element. In a two-tier structure, at least for listed companies, the management board should have further members in addition to the chief executive.

INDEPENDENCE: A KEY ATTRIBUTE

Non-executive directors and supervisory board members (NEDs)[2] have both a strategic role and a monitoring role to play in their companies. A key attribute of NEDs is their ability to be independent and act independently from management. Where the national law or codes require certain NEDs to be independent, the (supervisory) board, in its consideration of independence, should use a principles based approach[3] to assess threats and safeguards to independence. Within this approach, fundamental principles, which must always be observed, are defined and any threats, which could impede observance of these principles, should be identified. Where threats exist, safeguards should be put in place to eliminate or reduce them to an acceptable level. If no appropriate safeguard can eliminate or reduce the risk to an acceptable level, the only safeguard consists in either refraining from participating in the decision making process or resigning. This principles based approach including guidance and restrictions, combined with prohibitions where appropriate, should give more satisfactory results than a lengthy set of detailed rules, the spirit of which can be circumvented.

Independent NEDs also need to be seen to be independent. Disclosure is therefore important. The (supervisory) board should, in addition to identifying the NEDs it determines to be independent with due regard to threats and safeguards, publish its reasons for considering a NED to be independent in the corporate governance statement in its annual report. Such disclosure should include the existence of relationships or circumstances which shareholders (and where relevant, other legitimate stakeholders, such as employees) might reasonably consider relevant to its determination.

One dilemma for NEDs is how much to be involved in a business. FEE supports the Winter Group and Commission's recommendations that NEDs, on an individual basis, should limit the number of non-executive or advisory positions that they accept, and make this transparent. Listed companies should be required to disclose what board positions in other companies their non-executive or supervisory directors hold. FEE also believes that it would be appropriate for each individual to disclose significant board or equivalent positions that are held in public or not for profit sector bodies.

[2] To make the paper easier to read, the following chapters will only refer to the term "NEDs", which will also cover the members of a supervisory board in a two-tier system unless indicated otherwise.

[3] The FEE Paper A Conceptual Approach to Independence in the Financial Reporting Chain discusses how the framework approach can be applied in assessing the independence of non-executive directors and members of the audit committee.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

COMPETENCE

The competence of NEDs is also important to corporate governance. FEE agrees with the Winter Group that "in order for shareholders to be able to place sufficient trust in the non-executive or supervisory directors, they should be informed about their particular competencies in light of the board's composition. Listed companies should include in their annual corporate governance statement a profile of the board's composition, and should explain why individual non-executive directors or supervisory directors are qualified to serve on the board in the light of this profile. Again, there should be similar disclosures in proposals for initial appointment." We note that the Commission's Communication on Company Law and Corporate Governance also proposes disclosure by listed companies of the composition and operation of the board and its committees.

AUDIT COMMITTEE FUNCTION FOR ALL LISTED COMPANIES

A key part of NEDs' contribution to corporate governance is through active membership of the audit committee. All listed companies should have an audit committee function discharged by non-executive directors or supervisory board members of which there should be at least three in number where, at a minimum, the majority of the committee's members are independent. The members of the audit committee should be appointed by the (supervisory) board. FEE recommends that under a unitary board system all listed companies should be obliged to have an audit committee. Under a two-tier board system all supervisory boards of listed companies above a certain company size should have audit committees. The full responsibility for the review of financial reporting and other matters remains with the entire (supervisory) board. A company should indicate in its corporate governance statement when it has no audit committee and give the reasons why, and explain how the audit committee function has been discharged.

The external auditor, representatives of the executive directors/management board and senior management and the internal auditors should all meet the audit committee on appropriate occasions during the year to assist the audit committee in reviewing the relevant financial information and audit related activities of each and to ensure that each of these parties is properly discharging his responsibilities.

At least once a year the audit committee should meet privately with the external auditors and (separately) the internal auditors without the presence of other directors to discuss any matters of concern. Such matters could include concerns regarding the financial statements, internal control, the senior financial management team, or (where relevant to the committee's terms of reference) risk management, whistle blowing, ethics or relevant compliance matters.

There is a risk that audit committees can weaken the role of the auditor vis-à-vis the (supervisory) board as a whole, when the board may appear to have delegated its responsibilities to the audit committee. Measures should be put in place to ensure that all members of the (supervisory) board are given the opportunity to be fully informed about work of the audit committee. Regardless of any detailed discussions the auditor has with the audit committee, he should always have the right to attend (supervisory) board meetings in which financial statements and related audit issues are discussed. Moreover there should be a right for any party involved in the process (audit committee, management, (supervisory) board and auditor) to ask for full (supervisory) board consideration of these audit issues.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

1.3 Internal Control

RISK EVALUATION AND CONTROL

Systems of internal control and risk management are fundamental to the successful operation of any company, not only for financial reporting purposes but also for the day to day running of the company to help it achieve its business objectives.

As the risks facing a company are continually changing, the board should ensure a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed and the controls to manage them. Since profits are, in part, the reward for successful risk taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it. It is important to embed risk management into a business. The board of a company, its management and the company's internal audit function are concerned with the management of all the significant risks facing a company, some of which may be directly related to financial reporting.

ASSESSMENT OF INTERNAL CONTROL SYSTEMS

A company's (management) board should adopt a risk-based approach to establishing a sound system of internal control and for the (supervisory) board's review of its effectiveness. This approach should be incorporated by the company within its normal management and governance processes.

While assessment of the effectiveness of internal control in enterprises for internal purposes should be encouraged, external reporting on the effectiveness of internal control presents considerable challenges and should be subject for further discussion and exploration. Boards should consider the wider aspects of internal control as risk can have significant impact on the company's financial results and statements. FEE is at present undertaking a new project on internal control which aims to develop a position on how directors and auditors can responsibly report on companies' systems of internal control in ways that serve the public interest. There is a clear need for guidance in this area.

PUBLIC REPORTING ON INTERNAL CONTROLS?

Any proposal for public reporting on the effectiveness of internal controls raises several issues which require thorough consideration and debate. Public reporting of weaknesses in internal controls may present reputational risks to a company and may undermine the viability of the company, particularly companies in the financial services industry. Anything less than a clean bill of health could be harmful for the company. There are few companies that are not capable of improvement in some parts of their internal control systems. The discussion should provide clarity on what is meant by internal control; there should be realism on what internal control can and cannot do and how it can be assessed and reported upon. It should be remembered that the directors of a company could report only on their own processes for reviewing the effectiveness of the company's systems of internal control without getting into the more difficult area (for both boards and auditors) of reporting whether the company's controls are effective. Part of the discussion of a new FEE project on internal control will be on internal controls in relation to financial reporting. A distinction should also be made between reporting by directors and reporting by the external auditor. The issue should be considered in the light of the existing experience in Europe and the practical experience that is likely to become available in the US.

FEE recommends that further research and exploration is required with regard to the criteria for assessing the effectiveness of internal controls.

ETHICS

Integrity and ethics are key elements of the control environment. In any organisation, the leaders are responsible for setting the ethical tone and leading by example. Boards should ensure that the company has an ethical code and that they and their staff understand and apply it. Management and staff need to feel free to talk about concerns without fear of reprisal. The (supervisory) board should ensure that management creates a supportive environment for this communication to occur.

1.4 Internal Audit

SIGNIFICANCE OF INTERNAL AUDIT FUNCTION

An effective internal audit function can play a significant role within the corporate governance framework of a company. Over the last decade internal audit has developed and grown in importance. Internal audit is an independent and objective appraisal function. The remit of internal audit is both company and country specific. Its responsibilities and the reporting lines vary between countries with a two-tier system. Depending on the corporate governance system the internal audit function supports senior management, the (management) and/or the (supervisory) board.

Whilst acknowledging the importance of internal financial control in the current environment where there is a need to improve confidence in financial reporting, FEE recommends that the remit of internal audit functions should continue to have a significant focus on assessing the wider aspects of internal control which are linked to the management of risks facing a company.

INTERNAL AUDIT FUNCTION NOT UNDER DIRECT CONTROL OF MANAGEMENT

Where the internal audit function is not under the direct control of management (which is the case in many Member States), the internal audit function should have an independent professional reporting line directly to the audit committee with the Head of Internal Audit normally invited on a regular basis to attend its meetings. This reporting line assists the internal audit function in maintaining its objectivity by being able to communicate the results of its work to the audit committee without interference from management.

The audit committee should monitor and review the activities and effectiveness of the internal audit function and should review and approve the internal audit function's remit. The audit committee will need to decide if, and how, internal audit and external audit should work together, bearing in mind the different roles of each of the two audit functions.

The audit committee should approve the appointment of the Head of Internal Audit. It should also consider the resignation or approve the termination of appointment of the Head of Internal Audit after sufficient enquiry to be satisfied with the reasons for resignation and termination.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

The audit committee, in its review of the work of the internal audit function, should, inter alia:

- Ensure that the Head of Internal Audit has direct access to the chairman of the board/supervisory board as well as to the audit committee;
- Ensure that the internal audit function is professionally accountable to the audit committee;
- Review and assess the internal audit work plans;
- Receive regular reports on the execution of the internal audit function's work plans and an annual report from the internal audit function;
- Review and monitor management's responsiveness to the findings and recommendations of the internal audit function;
- Meet the Head of Internal Audit at least once a year without the presence of management; and
- Monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

ROLE OF INTERNAL AUDIT FUNCTION UNDER DIRECT CONTROL OF MANAGEMENT

Where the internal audit function reports professionally to management (such as in Austria and Germany), the supervisory board should receive a summary of the work and findings of internal audit and satisfy itself that the internal audit function is carrying out its objective appraisal function adequately.

NO INTERNAL AUDIT FUNCTION: DISCLOSURE

Where there is no internal audit function at all, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board. Reasons for the absence of an internal audit function should be explained in the corporate governance section of the annual report.

INTERNAL AUDIT FUNCTION AND CONTROL ENVIRONMENT

The internal audit function should consider significant exposures to risk and assist the board and senior management to maintain effective control by evaluating the company's response to risk and by promoting continuous improvement in the effectiveness and efficiency of operations.

Internal auditors should ascertain the extent to which management has established suitable criteria to determine whether objectives are being achieved. If adequate, internal auditors should use such criteria in their work. If inadequate, internal auditors should work with management to develop evaluation criteria that are appropriate to the specific circumstances of the company.

RESOURCES AND ACCESS TO INFORMATION

A key feature of the expanding role, and increasing expectations, of an internal audit function is the resources and skills base to which it has access. FEE believes that the body within the company responsible for agreeing upon the remit of the internal audit function (such as the audit committee) should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and that it is equipped to perform in accordance with appropriate professional standards for internal auditors.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

1.5 Disclosure about corporate governance

COMPREHENSIVE DISCLOSURE ON CORPORATE GOVERNANCE

FEE agrees with the Winter Group and the Commission's Communication on Company Law and Corporate Governance that disclosure is a powerful tool to improve corporate governance. FEE therefore supports the recommendation to require companies to make a comprehensive corporate governance statement in their annual reports. Responsibility for such a statement should rest with the board, which in a two-tier system means both the management and the supervisory boards.

FEE sees the need for an agreed framework for corporate governance reporting setting out common principles on the form and content of such reports. While considerable progress has been made in identifying the core issues to be reported, little progress has been made in establishing the conceptual underpinning that any form of public reporting requires. FEE would be willing to work with other parties to develop such a conceptual framework.

As financial reporting and corporate governance reporting overlap there could be uncertainty whether to disclose certain matters in the financial statements and in the directors' report or in a corporate governance report. It would therefore be desirable for countries to move towards a consensus on where new disclosure items should appear.

MINORITY SHAREHOLDERS

The interests of minority shareholders must be protected. It is therefore vital that all shareholders receive information equally. All disclosures relating to financial and non-financial performance and corporate governance should be timely and made available to all shareholders at the same time. The timeliness and equality of disclosure should be monitored by the (supervisory) board.

INTERNAL CONTROL DISCLOSURE

Internal control disclosure is part of a larger framework of disclosure of corporate governance performance. FEE believes that both shareholders and other relevant stakeholders require qualitative information about the processes that boards have undertaken to manage risk and assess internal control.

DISCLOSURES OF AUDIT COMMITTEE'S RESPONSIBILITIES AND ACTIVITIES

FEE recommends that information on the audit committee's responsibilities and activities should be provided as a part of the board's corporate governance statement. This will improve transparency, promote a better understanding of the work of the audit committee and help to reduce possible expectation gaps. Additional information could be included on a special page devoted to the audit committee on the company's website.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

1.6 External Audit

COMMUNICATION AND DIALOGUE

The external auditor has a central role not only in application of accounting standards but also in the wider corporate governance system. An active and constructive dialogue between the external auditors, management and especially the audit committee and the (supervisory) board, is important, both to ensure that the external auditors are aware of relevant information in order to be able to draw reasonable conclusions on which to base the audit opinion and to inform management, the audit committee and the (supervisory) board on the results of the audit.

FEE recommends that the external auditors provide members of the audit committee and other members of the (supervisory) board with a basic understanding of the audit process, the specific audit strategy adopted for the company as well as the limitations of the audit process compared to the relevant risks to the company.

In order to ensure an active and constructive dialogue between those charged with monitoring and supervision and the external auditors a process should be established by which regular meetings are held during the year, both in the presence of management and independently of management.

LONG FORM REPORTING BY AUDITORS TO BOARDS

FEE recommends that (supervisory) boards explore the use of extended (usually referred to as "long form") reports to boards by external auditors in combination with oral presentations and discussions allowing for more informal and in-depth exchange of views between the auditor and the audit committee or board. This would provide improved clarity and focus for the benefit of the (supervisory) board and audit committee in fulfilling their responsibilities.

AUDITORS' VIEW ON ACCOUNTING POLICIES AND JUDGEMENTS

FEE also recommends that the external auditors should communicate to the audit committee the company's significant accounting policies and practices including, where appropriate, alternatives and their assessment of the principal accounting judgements exercised.

INDEPENDENT ASSURANCE ON CORPORATE GOVERNANCE STATEMENTS?

FEE encourages debate on whether capital market participants see benefits in independent assurance on the corporate governance statement. However, the external auditor can express an opinion on whether only certain aspects of the corporate governance statement comply with certain defined reporting requirements and/or guidance – which have yet to be developed. Respecting the limitations of the auditor's role resulting from the audit approach and the role of the auditor within corporate governance, FEE recommends extending the scope of the external audit to require the auditor to examine whether certain appropriate aspects of the corporate governance statement comply with the respective reporting standards. FEE encourages all parties involved in the EU corporate governance discussion to work on a EU-wide common "comply or explain" approach on this issue.

1.7 Audit Committees

AUDIT COMMITTEE RESPONSIBILITIES

The audit committee undertakes certain tasks on behalf of the (supervisory) board which retains overall responsibility for financial reporting and other related matters. The audit committee's role and responsibilities, included in its terms of reference, should be agreed with the (supervisory) board. Each company is unique and therefore the committee's terms of reference need to suit the individual circumstances of the company, subject to a fundamental core of responsibilities that should apply to audit committees for all listed companies.

FEE suggests that the audit committee's "core responsibilities" should include:

- Reviewing financial reporting arrangements: including the review of the interim and annual financial statements, the other financial information published by the company, including related party disclosures, and internal control related to financial reporting to ensure overall balance and transparency;
- Monitoring the relationship with the external auditor; and
- Monitoring the work and resources of the internal audit function.

The audit committee not only reviews the financial statements but also needs to examine the other published financial information that the markets are most interested in, including the operating review/management discussion and analysis (MD&A), preliminary announcements, pro-forma information, GAAP vs non-GAAP headline figures and forecasts in order to ensure overall balance and transparency in the financial information published by the company. The audit committee should also be satisfied with related party disclosures as part of the more transparent disclosure of groups envisaged following the Winter Group recommendations and the Commission's Communication on Company Law and Corporate Governance.

In addition to its core functions, FEE recommends that the responsibilities of the audit committee should include reviewing:

- Wider aspects of internal control linked to the significant business risks faced by the company when not addressed by a separate specialised risk committee;
- The company's policy and practice to aid the prevention and detection of fraud;
- The company's policy and practice of corporate conduct and business ethics; and
- Its policies for ensuring that the company complies with relevant regulatory and legal requirements.

Whether the audit committee can deal with the above issues on behalf of the (supervisory) board without any further involvement of the entire (supervisory) board or whether the audit committee can act only as a preparatory committee with ultimate responsibility resting with the (supervisory) board depends on legislation in particular countries.

Where the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, the committee should make recommendations to the (supervisory) board on the action that it thinks is needed to address the issue or to make improvements and monitor action taken.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

FEE suggests that the audit committee's work in relation to external audit should include:

- Playing a key role in the proposed selection and appointment of external auditors and in agreeing and approving the terms and conditions of the audit;
- Monitoring the relationship of the external auditors with the company and its management during the course of the audit to safeguard the auditors' independence.

PURCHASING POLICY FOR NON-AUDIT SERVICES

The audit committee should establish – or, depending on the governance structure, at least formulate and recommend - its policy on purchasing non-audit services in line with any applicable legislation, bearing in mind guidance and best practices; it should ensure that, whilst allowing sufficient flexibility to take account of new situations, the overall policy is adhered to and keep under review the external auditors' role and independence. Elements of such a purchasing policy may include:

- Approval of a range of audit related and other services such as due diligence and taxation;
- Delegation to management of an authority to purchase such services up to an agreed parameter;
- Provision for specific approval for large or sensitive assignments; specifically, however, FEE believes that it is not appropriate for the audit committee to approve each individual contract for non-audit services; and
- Provision for regular reporting to the audit committee by management.

The audit committee's report that is included in the board's annual report to shareholders should set out its policy on non-audit services and explain its assessment that there are sufficient safeguards to ensure independence in relation to the provision of these non-audit services.

2 INTRODUCTION

2.1 Background

Recent corporate collapses, particularly in the US, have seriously undermined confidence in the capital markets as well as the public's trust in corporations, investment analysts, bankers, lawyers and accountants - both as preparers and as auditors of financial statements. Interest in corporate governance has been growing in reaction to the role of accounting errors or fraud in the demise of a number of important companies. Many of the failures could be attributed to a lack of integrity on the part of management where individuals were involved in aggressive accounting, earnings management or fraudulent financial reporting to manipulate share prices, borrowings and bonus plans.

These corporate failures, and the demise of Andersen, highlight the correctional power of the market, but the market's solution may not have been the best one as it contributed to the substantial loss of value in stock markets around the world. There is now a clear need to restore confidence in capital markets and elsewhere by enhancing corporate governance in order to provide financial information of the highest quality.

The US put forward its response through the Sarbanes-Oxley Act, rules adopted by the SEC and proposed new rules on corporate governance from the New York Stock Exchange. The Sarbanes-Oxley Act had significant focus on the role of external auditors and their independence and relationship with members of the audit committee. The aim was clearly to strengthen the relationship between external auditors and the non-executive directors on the audit committee and to improve the integrity of company management and financial reporting.

Europe is continuing to enhance corporate governance practice through the development of corporate governance codes and "soft law" linked to the "comply or explain" principle. This approach uses disclosure, rather than legislation, as a regulatory tool. The High Level Group of Company Law Experts (the Winter Group) made recommendations on corporate governance to the Commission. Their report, "A Modern Regulatory Framework for Company Law in Europe" (referred to here as the Winter Group Report) was published in November 2002. On 21 May 2003 the Commission's Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" (referred to here as Commission's Communication on Company Law and Corporate Governance) was issued as the Commission's response to the Winter Group Report, explaining why the European framework for company law and corporate governance needs to be modernised and setting out an action plan with priorities for the short, medium and long term. The Commission's Communication "Reinforcing the Statutory Audit in the EU" (referred to here as Commission's Communication on Statutory Audit) was also issued on 21 May 2003. It addresses corporate governance in relation to statutory audit, audit committees and internal control. FEE generally welcomes the recommendations on corporate governance in the Winter Group Report and in the Commission's Communications and where appropriate and relevant, this paper makes reference to these recommendations in this report[4].

[4] FEE Policy on EC Communications (21 May 2003)

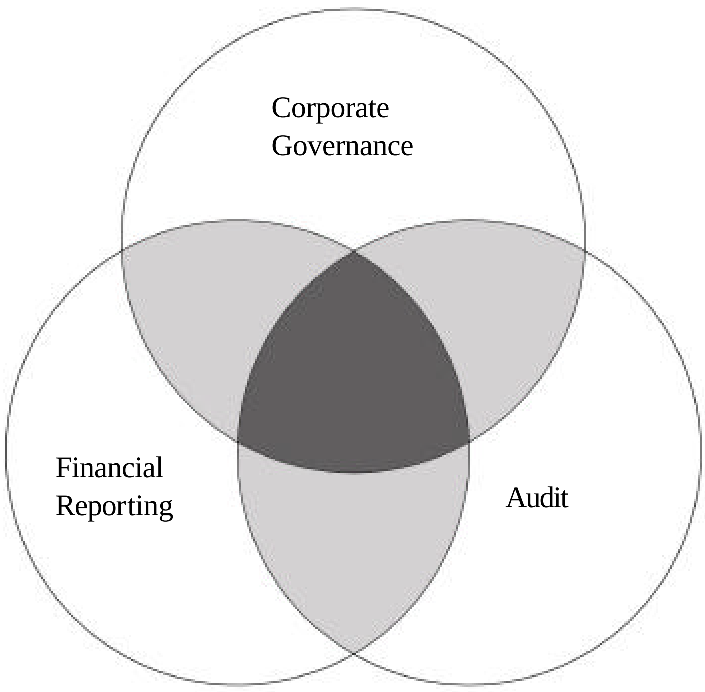
2.2 Objectives and Scope

European accountants, through their involvement in financial reporting and audit, are closely involved in corporate governance. The purpose of this FEE discussion paper is to consider the role of sound corporate governance in financial reporting and auditing and make practical recommendations from the perspective of the European accountancy profession. Confidence in financial reporting, and in audit, is a key factor in ensuring confidence in capital markets. This paper aims to contribute to restoring this confidence by offering the accountancy profession's perspective as part of the ongoing debate.

The paper describes the elements of good corporate governance relevant to the process of financial reporting and auditing. It highlights the importance of internal control and the pre-requisites for sound corporate governance including structures, relationships and behaviour. In particular it considers the fundamental relationships and obligations between company boards, auditors, and shareholders.

The paper recognises the importance of other than pure financial issues such as sustainability including economic, social and environmental performance, corporate social responsibility and intangible assets including reputation and brand names, but does not address these issues in detail.

This FEE discussion paper is concerned with the intersection and mutual dependency between financial reporting, corporate governance and audit.



The intersecting areas include:

- Internal control,
- Financial reporting including financial statements and accounting policies,
- Oversight by non-executive directors including activities of the audit committee,
- Reporting by external auditors to shareholders and management,
- Internal audit,
- Shareholders' meeting.

Although the focus is on publicly listed companies, the paper is nevertheless also relevant to many other non-listed companies, including public interest companies but also public and not for profit bodies. The paper should be relevant equally to companies with unitary and two-tier board systems, although there will of course be differences in how recommendations are implemented.

This paper does not attempt to address matters outside the intersection area. It therefore does not address other important aspects of corporate governance, such as the work of remuneration and nomination committees or sustainability and corporate social responsibility. Nor does it address the detail of the technical audit process, instead it focuses on the role of the external auditor in the corporate governance system and the contribution of the external audit to improve corporate governance especially by means of appropriate communication of the findings of the audit to the bodies responsible for the governance of the company.

In certain industries, such as the banking and insurance industry, special issues may arise, for example the role of the external auditor in the supervisory process and the relationship with actuaries. This paper is not aimed at addressing industry specific issues.

There is a public expectation of the contribution of the accountancy profession and the profession faces significant challenges going forward. FEE, as the representative body of the European accountancy profession, has a profound interest in these matters and has a unique contribution to make.

2.3 Corporate Governance

Corporate governance has been defined in a number of ways throughout the world[5]. The various definitions, however, have significant common ground. For the purpose of this discussion paper, the definition of Corporate Governance adopted by the OECD[6] is used:

"Corporate governance involves a set of relationships between a company´s management, its board, its shareholders and other stakeholders … and ... provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

OECD has set up principles regarding the following elements:

I. The rights of shareholders
II. The equitable treatment of shareholders

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[5] The Commission Communication on Company Law and Corporate Governance uses Cadbury definition "the system by which companies are directed and controlled", but refers also to the OECD definition.
[6] Organisation for Economic Co-operation and Development, Principles of Corporate Governance, 1999

III. The role of stakeholders in corporate governance
IV. Disclosure and transparency
V. The responsibilities of the board

Item V "The responsibilities of the board" it is stated that *"the board should fulfil certain key functions, including…ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law."*

The term "board", however, has different meanings in unitary and two-tier systems. A unitary board is comprised of executive and non-executive directors. In a two-tier system the term "board" is distinguished 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 among the two-tier systems, and the responsibilities of the supervisory board could in some countries include responsibilities for the strategic direction of the company. To reflect the different meanings of the term in a unitary and a two-tier system accurately, the terms will be specified in brackets where necessary.

The relative importance of shareholders and other stakeholders varies in the different corporate governance structures and cultures. These differences between jurisdictions need to be understood since they often explain the difficulties in finding common European solutions. Whether national corporate governance systems follow a shareholder or stakeholder approach may have, for example, consequences for the role of the external auditor (see for more details chapter 7).

Many codes on corporate governance have emerged during the 1990s. The Cadbury Committee set the agenda as a reaction to collapses in the UK during the late 1980s. Inter alia, Sir Adrian Cadbury set out to reduce the possibility of individuals gaining unrestricted control of an organisation. The UK, having a unitary board system, took up this challenge by strengthening the presence, number and quality of non-executive directors. Since then many countries have adopted codes in order to strengthen their corporate governance, including countries with two-tier board systems.

For example, in 2001 the German Minister of Justice set up the Cromme-Commission, developing a Code of Corporate Governance which both contains recommendations based on best practice and summarises the main legal requirements with regard to the corporate governance of a German stock corporation. The recommendations of the German Code, which go beyond the regulations laid down by law, are not binding. However, the German Stock Corporation Act requires the executive board and the supervisory board to state annually whether they have observed the recommendations of the Code and, in case of non-compliance, why and to what extent the recommendations are not complied with.

A similar approach has been adopted in Italy where the Italian Stock Exchange has issued a code of conduct for its particular unitary system (see 3.1).

Following the publication of the two Viénot reports in July 1995 and July 1999, and the law of May 15, 2001 on "New Economic Regulations", France has an extensive set of rules of corporate governance. Seeking more efficiency and transparency in listed companies, the Bouton report was released in September 2002 focusing on composition and function of the board. The law on Financial Security, currently being discussed by the French Parliament, will enshrine a part of these recommendations.

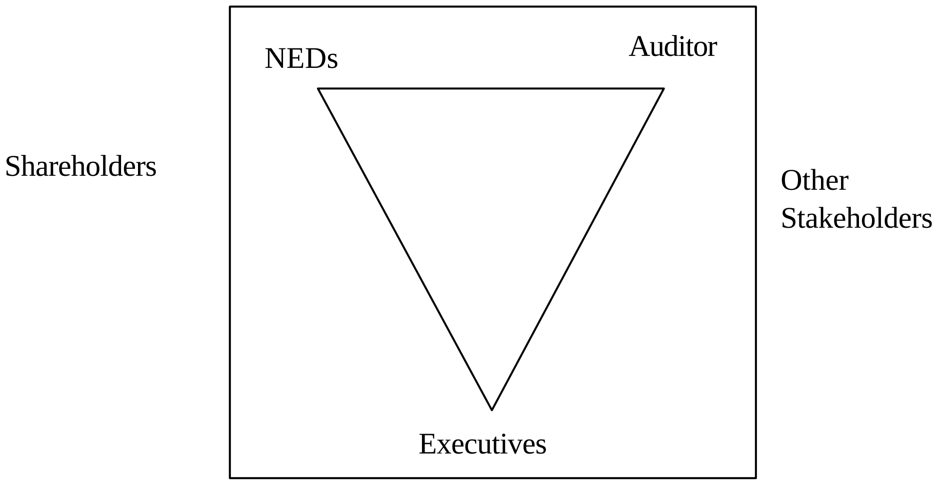
Several studies, such as the survey of corporate governance codes in Europe[7], have indicated that there has been considerable convergence in the codes of corporate governance on a global basis. This convergence in codes is influencing convergence of practice.

FEE supports the conclusions of the Jaap Winter Group and the Commission's Communication on Company Law and Corporate Governance that there is no need for a separate European Corporate Governance Code. However, some principles and common benchmarks for national codes (soft law) of corporate governance should be set at European level, together with guidance on the "comply or explain" approach to corporate governance advocated in the Jaap Winter Group Report. The Commission's Communication confirms that a common approach should be adopted at EU level with respect to a few essential rules and adequate co-ordination of corporate governance codes should be ensured.

2.4 Corporate Governance Relationships

The OECD definition makes it clear that corporate governance is about the relationships between a company's management[8], its board, its shareholders and other stakeholders. It follows that these relationships, and the relationship between all of these parties and the external auditor, must be clearly understood. Like the OECD, the Winter Group Report also emphasises that corporate governance is a system setting out relationships between the various participants.

Corporate Governance Relationships



[7] Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States on behalf of the European Commission (January 2002)

[8] The term of "management" may have different connotations in the context of a two-tier and a unitary system. Different terms are used: Board, Executive Board, executive directors, Management Board, Board of Directors, etc. The term "management" sometimes is also used to cover executives that are not members of the board. In order to indicate what is covered by "management" recognising the differences of a one-tier and a two-tier system, the term "management in this paper will be used for those board members with executive responsibilities. Where the term "directors" is used both management and non-executive directors are meant.

In most countries in Europe, directors, technically, are appointed by shareholders but in some listed companies, the substance is that the board chooses when to appoint or dismiss a director and shareholders merely ratify a decision to appoint. Similarly, although shareholders may formally elect the external auditors, in practice decisions on appointment were often taken by executive directors. Enron and WorldCom highlighted the importance of the external auditor's primary relationship being with shareholders and of both the auditors, and the directors being genuinely accountable to, shareholders. The best response to these problems may therefore be found in achieving more appropriate relationships and communication between the main parties in the corporate governance process. In some countries, also the relationship with other stakeholders and a proper consultation of these stakeholders should be considered.

Both, NEDs in a unitary board and the supervisory board in a two-tier system, have an important task in balancing the power of the management to prevent actions that favour management over the interests of shareholders and other relevant stakeholders, or favour one shareholder over other shareholders. The independent external auditor is an important source of information for the non-executive directors and for the supervisory board helping them to assess monitoring procedures and external reporting (for more details see chapter 7.3). On the other hand auditors have to place reliance on executive directors and use non-executive directors as a source of information. Therefore, the objectivity of auditors must be carefully safeguarded. Shareholders depend on the quality of board members, non-executive board members as well as supervisory board members. All of them – shareholders, board members, non-executive board members and supervisory board members – depend on the quality of the external audit, and the external auditors rely on the integrity both of the management and the non-executive directors and supervisory board members. Increasingly it is recognised that the auditor's key reporting relationship to the shareholders is achieved through communicating with the non-executive directors on the audit committee. In some jurisdictions the auditor has a wider reporting responsibility than reporting to the company or to the shareholders, in reporting to the public in general, including all stakeholders. Attention needs to be given to the fact that this difference in reporting can have an impact on the liability of the auditor and needs to be paid attention to (see chapter 7.1).

For two-tier systems the role of the supervisory board is being discussed and the relationships between boards and auditors strengthened – in many countries through establishment of audit committees. Better understanding through interaction and communication between supervisory boards and auditors can improve the value of the non-executive presence in supervisory boards to balance the control of the executives over the financial reporting process.

2.5 Enforcement

As expressed in its April 2002 Discussion Paper on Enforcement of IFRS (International Financial Reporting Standards) within Europe, FEE believes that there is a need to strengthen corporate governance arrangements so that they are equally effective across Europe in relation to financial information prepared using IFRS. FEE defined the following principal elements, which are all part of the corporate governance system, for a framework of high quality financial reporting:

Internal to the organisation

- Effective internal control
- Preparation of true and fair financial information by an effective and a well resourced company accounting function
- Internal audit function with appropriate level of resources, competence and lines of accountability
- Oversight of the reporting process and informed review by directors, audit committees or supervisory boards
- Proper approval procedures for financial information by the body responsible within the company

External to the organisation

- Proper financial reporting standards
- External audit, subject to quality assurance systems which inspire public confidence
- Effective enforcement bodies
- Stock Exchanges with effective listing agreements
- Sponsors, advisers and investment bankers committed to high quality financial reporting particularly in respect of complex transactions
- Investors, analysts, rating agencies and the financial press, all of which should have clear ethical obligations to raise issues of dubious financial reporting

It is important that all parties in this framework behave ethically. Within a company there should be a clear ethical obligation for people to raise issues of ethical concern (see 4.5.3), in the first instance with the company, its audit committee or supervisory board and in second instance, if direct liaison with the company is unsatisfactory, to consider doing so, with the appropriate enforcement body. In addition, all the parties should be subject to appropriate enforcement, in its broader sense, in relation to their responsibilities to support high quality financial reporting.

In the context of financial reporting, FEE defines enforcement as a system to prevent, whenever possible, and thereafter to identify and correct, material errors or omissions in the application of IFRS in financial information and other regulatory statements issued to the public. FEE's discussion paper on enforcement concentrates on the role of external enforcement bodies. The enforcement paper, however, also says that enforcement bodies must support effective functioning of management, supervisory boards or audit committees and external audit. This paper is concerned with these particular parties.

Measures to secure high quality external audit include:

- Professional standards requiring the external auditor to implement appropriate policies and procedures within the firm to ensure that audits are conducted in accordance with professional requirements and relevant auditing standards;
- An external quality assurance system to assess whether and to what extent the auditor has fulfilled his responsibility to implement and maintain an adequate and effective functioning internal quality control system;
- A disciplinary regime for sanctioning neglects of professional duties;
- Public oversight.

Enforcement of corporate governance is rather different. Different EU countries will each have their own means of achieving corporate governance performance and adherence to corporate governance principles, whether or not enshrined in a code. How countries achieve good governance for their companies will depend upon each country's tapestry of laws, institutions, government regulators and culture. However, it seems that most countries have adopted the approach of having a voluntary code reinforced by disclosure on a "comply or explain" basis facilitates transparency in the corporate governance behaviour of each listed company. Disclosure of corporate governance practice is discussed in chapter 6.

FEE supports the Winter Group view that enforcement of good corporate governance based on voluntary codes, disclosure and market pressure is preferable to an enforcement system based on detailed legislation on corporate governance procedure. FEE agrees with the Commission's vision in the Company Law and Corporate Governance Communication that there is an active role for the EU to play in corporate governance. In view of the growing integration of European capital markets, a common approach should be adopted at EU level with respect to a few essential principles and adequate co-ordination of corporate governance codes should be ensured, in order to encourage further convergence and the exchange of best practice.

<u>Recommendation</u>

2.1 FEE supports the conclusions of the Jaap Winter Group and the Commission's Communication on Company Law and Corporate Governance that there is no need for a separate European Corporate Governance Code. However, some principles and common benchmarks for national codes (soft law) of corporate governance should be set at European level, together with guidance on the "comply or explain" approach to corporate governance advocated in the Jaap Winter Group Report. The Commission's Communication confirms that a common approach should be adopted at EU level with respect to a few essential rules and adequate co-ordination of corporate governance codes should be ensured.

3 NON-EXECUTIVE DIRECTORS AND THE SUPERVISORY BOARD – A FOCAL POINT OF GOOD CORPORATE GOVERNANCE

Non-executive directors (NEDs) in a unitary and the supervisory board in a two-tier system offer a strong base for managing the risk of companies ignoring their shareholders' interests and the legitimate interests of other relevant stakeholders. They have a role in ensuring that important governance issues are properly addressed and ensuring objectivity in the financial reporting process which can have a positive influence on the value and efficiency of audits. This derives from the fact that they, by their presence, have a role in balancing the influence of management in many ways, e.g. acting on recommendations and observations of the auditors, improving the control environment, and bringing independence to bear on decisions regarding accounting principles and accounting estimates. Therefore, FEE recognises NEDs and the supervisory board as fundamental to the quality of corporate governance.

To make the paper easier to read, the following chapters will only refer to the term "NEDs", which will also cover the members of a supervisory board in a two-tier system unless indicated otherwise.

3.1 Board Structures

In the EU, two main types of board structure are found in listed companies, these are the unitary board system and the two-tier board system.

In a unitary board the whole board is responsible to shareholders for the successful stewardship, including preparation of reliable financial statements, of a company. Following recommendations based on best practice from the UK Cadbury Committee, virtually all unitary boards of listed companies contain NEDs as well as executive directors. There is presently active debate about the role and responsibility of NEDs and about the need for, and how to identify, independent directors. In a unitary board, however, company law does not define or attempt to distinguish between different types of director. A NED is generally taken to mean a director without executive functions. Best practice suggests that NEDs have both a strategic and a monitoring role. Participation as a member of an audit committee is a prime example of NEDs acting in a monitoring role. Executive directors, of course, have executive functions and they have primary responsibility for managing the company.

In a two-tier structure, a company has both a management board and a supervisory board. The management board runs the company under its own authority, develops the company's strategy and is responsible for the running of day to day operations, whereas the supervisory board appoints and monitors the members of the management board. However, the respective roles of the management board and the supervisory board may vary between countries having adopted two-tier systems. In some countries the role is limited to a monitoring function whereas other countries rely on the supervisory board to take strategic decisions and be responsible for the overall direction of the company. In most jurisdictions with two-tier board systems the supervisory board, in performing its monitoring function, is required to examine and approve the financial statements prepared by the management board. Furthermore, the supervisory board can stipulate particular types of business into which the management board may enter only with its approval. In some countries, such as Germany, employees may also nominate members of the supervisory board.

In Italy a special unitary system structure can be found, in which in addition to a board of directors, comprising executive and non-executive directors, Italian legislation on listed companies provides for a "board of statutory auditors" (collegio sindacale). This is a corporate body formed by independent professionals which fulfils a role similar to that of the supervisory board or the audit committee.

A recent survey of corporate governance codes in Europe[9] concluded "notwithstanding structural differences between two-tier and unitary board systems, the similarities in actual board practices are significant. Both types of systems recognise a supervisory function and a managerial function, although the distinctions between the two functions tend to be more formalised in the two-tier structure". The study also noted considerable convergence in the many corporate governance codes in the EU.

The fundamentals of good corporate governance are the same for both types of board structure. FEE supports the view held by the Winter Group and expressed in the Commission's Communication on Company Law and Corporate Governance that in the long run both types of board structure should be permissible, at least for listed companies. The Commission announces in this respect a legislative initiative for the medium term.

All companies need able management but in any board system it is important to have an appropriate balance of power such that no single individual, or group, has unfettered control of the company. FEE therefore recommends, at least for listed companies, that in a unitary board, the roles of chairman and chief executive should be held by different people and that there should be at least two executive directors balanced by a strong independent non-executive element. In a two-tier structure, at least for listed companies, the management board should have further members in addition to the chief executive.

3.2 The Role of Non-executive Directors/Supervisory Board

In most jurisdictions, especially in those with a unitary system, NEDs have both a strategic role and a monitoring role to play in their companies. The events at Enron, WorldCom and Ahold highlighted deficiencies in the performance of the monitoring role. Events in the UK such as at Equitable Life and Marconi but also elsewhere in Europe such as Vivendi by contrast have highlighted strategic errors. In fulfilling their monitoring role, non-executive directors should bring balance to the potential dominance of the management by executive directors, particularly in areas where there is a risk of management taking advantage of their dominance at the expense of shareholders and other stakeholders. Such areas would include nomination of new board members (executive as well as non-executive), fixing the level of remuneration of executives and ensuring objectivity in financial reporting and disclosure.

Thus, in addition to their input on strategic matters, NEDs should have a distinct general monitoring role as well as monitoring specific areas where independent judgement is critical to representing the interests of shareholders in particular as well as other relevant stakeholders of the enterprise. It is a question open for debate – and the answer would vary from country to country - whether NEDs' responsibilities can be translated into a particular legal responsibility vis-à-vis shareholders and external stakeholders. In a unitary system, it is generally recognized that their role is to bring independent judgement to the boardroom as part of the overall stewardship of the company. If NEDs were to see themselves as "representatives" of particular

[9] Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States on behalf of the European Commission (January 2002)

stakeholder interests, this would create a potential conflict of interest and a risk of putting the interest of one stakeholder group above the company. In practice, in some smaller listed companies, NEDs are nominated by a particular investor group such as a venture capitalist and there is a potential for conflict of interest.

NEDs, through the way they exercise independent judgement, also have a vital role in ensuring the organisation, as a whole, behaves with integrity. They can also act as a corporate conscience for the company in matters of corporate and social responsibility.

FEE believes that NEDs can and should play an active role in ensuring that information is provided to all shareholders on an equal basis.

NEDs should encourage well run businesses to continue to be so and to encourage change in businesses that are less well run. The skills of entrepreneurial management and the need for accountability potentially conflict. It is when a business is less well run that the quality of information provided to NEDs by the management may be poorest and when the risks of collegiate responsibility may be at their greatest. It is then that the NEDs are called upon to act.

NEDs are now being expected to do more than many may be prepared to do. There is some uncertainty about the potential liability of NEDs and, as NEDs receive less remuneration than executive directors, will companies have problems finding NEDs who are prepared to rise to these challenges? This is a matter of concern.

The main tasks of the NEDs are to contribute to the overall collegiate responsibility of the board in a unitary system, and of the supervisory board in a two-tier system by:

- Strategy
    - Challenge and contribute to strategy
- Monitoring
    - Review the risk management practices and the internal control system of the company
    - Monitor the management's relationship with the internal and external auditors
    - Review and monitoring the ethics policy for the company
- External reporting
    - Oversee the reporting process
    - Liase with the external auditor
    - Review the annual and interim financial statements
    - Satisfy themselves that information reported to shareholders is true and fair
- Solving/preventing conflict of interests
    - Oversee recruitment of new directors (executives and non-executives) through the nomination committee
    - Deciding remuneration of directors (executives and non-executives) through the remuneration committee

3.3 *Attributes of a Successful NED*

3.3.1 Independence

A key attribute of NEDs is their ability to be independent and act independently from management. There should be sufficient independent NEDs to provide a balance to the executive directors and these independent directors each should be able to devote sufficient time to the company so as to have a thorough understanding of the company and its market to perform their duties.

Ethical issues, such as independence, cannot be adequately dealt with solely through rules, prohibitions and/or legislation.[10] Therefore, FEE recommends that, where the national law or codes require certain NEDs to be independent, the (supervisory) board, in its consideration of independence, should use a principles based approach to assess threats and safeguards to independence. Within this approach, fundamental principles, which must always be observed, are defined and any threats, which could impede observance of these principles, should be identified. Where threats exist, safeguards should be put in place to eliminate or reduce them to an acceptable level. If no appropriate safeguard can eliminate or reduce the risk to an acceptable level, the only safeguard consists in either refraining from participating in the decision making process or resigning. This principles based approach including guidance and restrictions, combined with prohibitions where appropriate, should give more satisfactory results than a lengthy set of detailed rules, the spirit of which can be circumvented.

Where the national law requires certain NEDs to be independent, the (supervisory) board could consider, in order to assess the specific threats, a suitable set of independence criteria as a guide but it is essential that the substance of independence is considered as well as the form. NEDs should understand the meaning of being, thinking and acting independently. All directors should be objective in their actions. Each NED should inform the board or supervisory board of any conflicts of interests or impairment of independence which may arise after their appointment.

Independent NEDs also need to be seen to be independent. Disclosure is therefore important. The (supervisory) board should, in addition to identifying the NEDs it determines to be independent with due regard to threats and safeguards, publish its reasons for considering a NED to be independent in the corporate governance statement in its annual report (see chapter 6). Such disclosure should include the existence of relationships or circumstances which shareholders (and where relevant, other legitimate stakeholders, such as employees) might reasonably consider relevant to its determination.

It is worth noting the lack of consistency around the world in assessing independence. The Winter Group Report provides a list of relationships which would cause a NED to be considered not to be independent. This list should only be seen as guidance to identify threats to independence. The particular circumstances, materiality and subjectivity should be taken into account in assessing the threats and safeguards. The same applies to the criteria directed in the US or recommended by Derek Higgs[11] for the UK as set out in the appendix to this paper. In Belgium, the corporate governance law of 2 August 2002 modifying the Company Code provides for criteria relating to directors' independence (into force as of 1 January 2004) for the purpose of specific procedures related to intra-group operations, as set out in the appendix to

[10] EC Recommendation on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles (May 2002)
FEE Paper A Conceptual Approach to Independence in the Financial Reporting Chain (2003)
[11] The Role and Effectiveness of Non-Executive Directors by Derek Higgs on behalf the Department of Trade and Industry.

this paper. Similar requirements are included in the Italian Stock Exchange code of conduct. The French Bouton report requires that the board incorporates at least 50% independent directors.

The Commission's Communication on Company Law and Corporate Governance announces the establishment of certain minimum standards at EU level of what cannot be considered to be independent with particular emphasis on the number of mandates and interlocking directorships.

3.3.2 Involvement

One dilemma for NEDs is how much to be involved in a business. If they are involved as part of the decision making process they could be perceived as losing independence and becoming executives – if they are not involved at all, they are of no value. If they get too involved in details of the operations they may lose objectivity – if they do not get involved enough their knowledge could be insufficient to enable them to provide independent critical judgement. Balance is required.

The Winter Group Report states that: "The increased importance attached to the role of non-executive or supervisory directors today requires them to make sufficient time available to fulfil their responsibilities. This should cause non-executive and supervisory directors to limit the number of non-executive or supervisory positions they accept. What is an appropriate maximum number of non-executive or supervisory board positions will vary from person to person and according to the specific responsibilities involved in each position. In order to make this transparent to shareholders, listed companies should be required to disclose what board positions in other companies their non-executive or supervisory directors hold." We note that the Commission's Communication announced that "particular attention will be paid to the issue of the number of mandates that may be held concurrently."

FEE supports the Winter Group and Commission's recommendations that NEDs, on an individual basis, should limit the number of non-executive or advisory positions that they accept, and make this transparent. Listed companies should be required to disclose what board positions in other companies their non-executive or supervisory directors hold. FEE also believes that it would be appropriate for each individual to disclose significant board or equivalent positions that are held in public or not for profit sector bodies.

3.3.3 Competence

The competence of NEDs is another area important to the success of the existing corporate governance regime. If the NEDs do not understand the issues that are critical to their responsibilities, the value of their presence and independence is limited. Besides having a general knowledge of the business practices in order to form an independent view, personal attributes, such as integrity and interpersonal skills, are required. More specific skills are required when it comes to ensuring that financial reporting and disclosure is up to standard.

FEE considers that, however desirable, any legal requirement regarding financial literacy or expertise would be difficult to formalise. FEE agrees with the Winter Group that "in order for shareholders to be able to place sufficient trust in the non-executive or supervisory directors, they should be informed about their particular competencies in light of the board's composition. Listed companies should include in their annual corporate governance statement a profile of the board's composition, and should explain why individual non-executive directors or supervisory board members are qualified to serve on the board in the light of this profile. Again, there should be similar disclosures in proposals for initial appointment." We note that the Commission's Communication on Company Law and Corporate Governance also proposes disclosure by listed companies of the composition and operation of the board and its committees.

Many corporate governance codes call for boards and individual directors to assess their performance for example the French Bouton report calls for board evaluation and disclosure on the evaluation to shareholders.

3.4 Audit Committee Function

3.4.1 The importance of audit committees in corporate governance

Effective corporate governance requires the active and collaborative participation of the board (be it within the unitary or two-tier board system), the organisation's management, its auditors (internal audit and external audit), and its audit committee. The audit committee function is now a key element within the corporate governance framework. The Commission's Communication on Audit Strategy indicates that "audit committees can play an important role in the governance of a company by assisting the statutory auditors to stay at arm's length from management. Audit committees help to ensure high quality financial reporting and statutory audit as well as well functioning, effective internal control including internal audit practices". In addition the Commission's Communication on Company Law and Corporate Governance announces in the short term a Recommendation addressing amongst others, audit committees. "Special emphasis will be placed on the audit committee (or equivalent body), with a view to fostering the key role it should play in supervising the audit function, both in its external aspects (selecting the external auditor for appointment by shareholders, monitoring the relationship with the external auditor including non-audit fees if any) and its internal aspects (reviewing the accounting policies, and monitoring the internal audit procedures and the company's risk management system)[12]."

All listed companies should have an audit committee function discharged by non-executive directors or supervisory board members of which there should be at least three in number where, at a minimum, the majority of the committee's members are independent. The members of the audit committee should be appointed by the (supervisory) board. FEE recommends that under a unitary board system all listed companies should be obliged to have an audit committee. Under a two-tier board system all supervisory boards of listed companies above a certain company size should have audit committees. The full responsibility for the review of financial reporting and other matters remains with the entire (supervisory) board. A company should indicate in its corporate governance statement when it has no audit committee and give the reasons why, and explain how the audit committee function has been discharged.

Some countries have traditions for supervisory boards to carry out the audit committee function. Important elements to consider for supervisory boards in deciding whether a supervisory board will be able to discharge its responsibilities of the audit committee effectively without establishing and audit committee will be matters such as the size and complexity of the company, the size and capacity of the supervisory board and risk factors facing the company in general.

[12] In developing the minimum standards applicable to the audit committee, appropriate attention will be paid to a) the access it must have to the relevant information (there might be a scope for specific consideration of the need for greater legal protection for whistleblowers) and b) the extent to which transparency on its activities is desirable.

The audit committee's primary role is to help provide confidence to the (supervisory) board, and hence to investors, that the audited financial statements and other financial and non-financial information where relevant reported externally by the company's management is not misleading. Essentially the audit committee helps to ensure high quality financial reporting.

Having such a vital role, on behalf of the (supervisory) board, in the oversight of a company's reporting process, the audit committee will have to have appropriately experienced individuals with a strong sense of integrity, be properly constituted and adequately resourced. To undertake its work effectively the committee must:

- Have clear terms of reference, especially as to its role, responsibilities and authority;
- Ensure that it has relevant expertise amongst its membership and independent access to any expertise that it requires, and have unrestricted access to other resources to support the committee.

Audit committees, as a preparatory committee of the (supervisory) board, must undertake their work within the unitary/two-tier board system, avoiding the possibility of creating an additional, "quasi (supervisory) board". In a unitary system, financial statements and other financial information published by a company are the responsibility of the board as a whole, and the members of the board cannot be absolved from their responsibility for the financial statements just because the audit committee has undertaken detailed work on their behalf. The same applies in a two-tier system where the management board is responsible for the preparation of the financial statements and the supervisory board holds the responsibility for the approval of the financial statements which cannot be delegated to the audit committee. To fulfil its responsibilities in a proper way by taking into account the results of the work of the audit committee the (supervisory) board should ensure it is aware of the activities of its audit committee and receives and considers minutes of audit committee meetings. In certain jurisdictions the supervisory board as a whole is legally liable, if it is not fulfilling the discussions on the financial statements and audit. In certain countries, such as Ireland, audit committees have a separate legal status and recognition.

Nevertheless, members of an audit committee take on significant responsibilities on behalf of the (supervisory) board. Expectations of audit committees are now high, and rising. Care will have to be taken that audit committee members are not overloaded and caution has to be exercised to ensure that "expectation gaps" are not created.

There is a risk that audit committees can weaken the role of the auditor vis-à-vis the (supervisory) board as a whole, when the board may appear to have delegated its responsibilities to the audit committee. Measures should be put in place to ensure that all members of the (supervisory) board are given the opportunity to be fully informed about work of the audit committee. Regardless of any detailed discussions the auditor has with the audit committee, he should always have the right to attend (supervisory) board meetings in which financial statements and related audit issues are discussed. (In line with ISA 260 communications of audit matters with those charged with governance: "The auditor should communicate audit matters of governance[13] interest arising from the audit of financial statements with those charged with governance of an entity.") Moreover there should be a right for any party involved in the

[13] "Governance" in this context is the term used in ISA 260 "to describe the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions".

process (audit committee, management, (supervisory) board and auditor) to ask for full (supervisory) board consideration of these audit issues.

The responsibility of the audit committee is discussed in more detail in chapter 8.

3.4.2 Authority of the audit committee

The authority of the audit committee must not be restricted. The audit committee should have the explicit authority to:

- Obtain external independent professional advice;
- Have access to such resources and information from within the company as they consider necessary;
- Have access to any individual(s) in the company and to require them to attend committee meetings;
- Conduct their own special investigations on activities that fall within the committee's responsibilities;
- Consult with the external auditors on any relevant topic, including the external auditor's independence.

In addition, individual members should have authority to seek external independent advice.

3.4.3 Membership of the audit committee

The members of the audit committee should be appointed by the (supervisory) board. To enable the committee to discharge its responsibilities, all members of the audit committee, of which there should be at least three in number, must be non-executive or supervisory board members with a majority being independent.

The chairman of the audit committee is particularly important, he should be an independent non-executive or supervisory board member. There are good reasons for the chairman of the audit committee not being the chairman of the (supervisory) board. The CEO, CFO, external audit partner, Head of Internal Audit, may be invited to attend all or part of a committee meeting as appropriate, but cannot be members of the committee and must not vote at meetings.

3.4.4 Self-assessment and terms of reference

To help maintain quality, annually the audit committee should conduct a self-assessment of its own performance and its work plan seeking input from the (management and supervisory) board, senior management, the external and internal auditors and others. The results of the self-assessment should be communicated to the (supervisory) board. The (supervisory) board should review the results of the self-assessment by the audit committee and review and confirm its terms of reference.

3.4.5 Meetings of the audit committee

The audit committee chairman, in consultation with the committee secretary, must decide the frequency and timing of the committee's meetings. There should be sufficient meetings of sufficient length to enable the audit committee to meet the requirements of its terms of reference. FEE recommends that meetings be held to coincide with key dates within the financial reporting and audit cycle.

The external auditor, representatives of the executive directors/management board and senior management and the internal auditors should all meet the audit committee on appropriate occasions during the year to assist the audit committee in reviewing the relevant financial information and detail related activities of each and to ensure that each of these parties is properly discharging his responsibilities.

At least once a year the audit committee should meet privately with the external auditors and (separately) the internal auditors without the presence of other directors to discuss any matters of concern. Such matters could include concerns regarding the financial statements, internal control, the senior financial management team, or (where relevant to the committee's terms of reference) risk management, whistle blowing, ethics or relevant compliance matters.

3.5 Training

Critical to the effectiveness of NEDs, is the need for them to be familiar with their responsibilities, and to have a knowledge of the company's business and operations.

Companies should provide an effective company specific induction process, covering business knowledge and the main drivers of the business, site visits, current issues facing the business etc, for new NEDs. Furthermore, companies should arrange more general training and development for their NEDs e.g. on fiduciary duties and legal liabilities of directors, corporate governance, financial and other reporting requirements, other company law matters, and ongoing updates on such matters.

New members of an audit committee should undergo an induction programme to help them understand the requirements and objectives of the committee. To ensure that they have an appropriate understanding of the company, its products, the control environment, areas of risk, and the company's internal control and financial reporting systems as well as the work of the various functions that support the work of the committee, new committee members may spend time with individuals from:

- The finance function,
- The company secretary/secretary to boards,
- Other management functions,
- Internal audit, and
- External audit.

NEDs should be entitled to proper training and expert advice.

Recommendations

3.1 The relationships between executives, non-executives, shareholders and external auditors should be clearly understood by each party. The recommendations set out below should accomplish the understanding.

3.2 All companies need able management but in any board system it is important to have an appropriate balance of power such that no single individual, or group, has unfettered control of the company. FEE therefore recommends that in a unitary board, at least for listed companies, the roles of chairman and chief executive should be held by different people and that there should be at least two executive directors balanced by a strong independent non-executive element. In a two-tier structure, at least for listed companies, the management board should have further members in addition to the chief executive.

3.3 FEE believes that NEDs can and should play an active role in ensuring that information is provided to all shareholders on an equal basis.

3.4 Where the national law or codes require certain NEDs to be independent, the (supervisory) board, in its consideration of independence, should use a principles based approach to assess threats and safeguards to independence. Within this approach, fundamental principles, which must always be observed, are defined and any threats, which could impede observance of these principles, should be identified. Where threats exist, safeguards should be put in place to eliminate or reduce them to an acceptable level. If no appropriate safeguard can eliminate or reduce the risk to an acceptable level, the only safeguard consists in either refraining from participating in the decision making process or resigning. This principles based approach including guidance and restrictions, combined with prohibitions where appropriate, should give more satisfactory results than a lengthy set of detailed rules, the spirit of which can be circumvented.

3.5 The (supervisory) board should, in addition to identifying the NEDs it determines to be independent with due regard to threats and safeguards, publish its reasons for considering a NED to be independent in the corporate governance statement in its annual report. Such disclosure should include the existence of relationships or circumstances which shareholders (and where relevant, other legitimate stakeholders, such as employees) might reasonably consider relevant to its determination

3.6 FEE supports the Winter Group and Commission's recommendations that NEDs, on an individual basis, should limit the number of non-executive or advisory positions that they accept, and make this transparent. Listed companies should be required to disclose what board positions in other companies their non-executive or supervisory directors hold. FEE also believes that it would be appropriate for each individual to disclose significant board or equivalent positions that are held in public or not for profit sector bodies.

3.7 FEE agrees with the Winter Group that “in order for shareholders to be able to place sufficient trust in the non-executive or supervisory directors, they should be informed about their particular competencies in light of the board’s composition. Listed companies should include in their annual corporate governance statement a profile of the board’s composition, and should explain why individual non-executive directors or supervisory directors are qualified to serve on the board in the light of this profile. Again, there should be similar disclosures in proposals for initial appointment.” FEE notes that the Commission’s Communication on Company Law and Corporate Governance also proposes disclosure by listed companies of the composition and operation of the board and its committees.

3.8 All listed companies should have an audit committee function discharged by non-executive directors or supervisory board members of which there should be at least three in number where, at a minimum, the majority of the committee’s members are independent. The members of the audit committee should be appointed by the (supervisory) board. FEE recommends that under a unitary board system all listed companies should be obliged to have an audit committee. Under a two-tier board system all supervisory boards of listed companies above a certain company size should have audit committees. The full responsibility for the review of financial reporting and other matters remains with the entire (supervisory) board. A company should indicate in its corporate governance statement when it has no audit committee and give the reasons why, and explain how the audit committee function has been discharged.

3.9 There is a risk that audit committees can weaken of the role of the auditor vis-à-vis the (supervisory) board as a whole, when the board may appear to have delegated its responsibilities to the audit committee. Measures should be put in place to ensure that all members of the (supervisory) board are given the opportunity to be fully informed about work of the audit committee. Regardless of any detailed discussions the auditor has with the audit committee, he should always have the right to attend (supervisory) board meetings in which financial statements and related audit issues are discussed. (In line with ISA 260 communications of audit matters with those charged with governance: “The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.”) Moreover there should be a right for any party involved in the process (audit committee, management, (supervisory) board and auditor) to ask for full (supervisory) board consideration of these audit issues.

3.10 To help maintain quality, annually the audit committee should conduct a self-assessment of its own performance and its work plan seeking input from the (management and supervisory) board, senior management, the external and internal auditors and others. The results of the self-assessment should be communicated to the (supervisory) board. The (supervisory) board should review the results of the self-assessment by the audit committee and review and confirm its terms of reference.

3.11 The external auditor, representatives of the executive directors/management board and senior management and the internal auditors should all meet the audit committee on appropriate occasions during the year to assist the audit committee in reviewing the relevant financial information and audit related activities of each and to ensure that each of these parties is properly discharging his responsibilities.

3.12 At least once a year the audit committee should meet privately with the external auditors and (separately) the internal auditors without the presence of other directors to discuss any matters of concern. Such matters could include concerns regarding the financial statements, internal control, the senior financial management team, or (where relevant to the committee's terms of reference) risk management, whistle blowing, ethics or relevant compliance matters.

3.13 NEDs should be entitled to proper training and expert advice.

4 INTERNAL CONTROL

4.1 Introduction

Systems of internal control and risk management are fundamental to the successful operation of any company, not only for financial reporting purposes but also for the day to day running of the company to help it achieve its business objectives.

A company's objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

Systems of internal control will vary from company to company depending, inter-alia, on the:

- Unique circumstances of each company, its size and the complexity of the market place(s) in which it operates; and
- Methods by which these risks are managed and controlled, the level of control required and the costs and benefits of the various controls.

The Commission's Communication on Statutory Audit refers to the responsibility for and quality of a company's internal control system including the internal audit function as an important part of the corporate governance framework. The Commission proposes to examine the present situation in the EU on the external auditor's involvement in the assessment and reporting on internal control systems, to possibly come forward with proposals on this issue.

4.2 Different definitions of internal control

There are a number of definitions of internal control in various guidance documents such as Turnbull[14] (UK), COSO[15] (USA) and CoCo[16] (Canada). Whilst there are some differences in these definitions, essentially, internal control is a "process" established, operated and monitored by the board and management of a company to provide reasonable assurance regarding the achievement of the company's objectives.[17] "Process" is used in a broad sense; it goes beyond procedures and also includes elements such as corporate culture, systems, structure, policies and tasks. It is upon this "process" approach that much of the guidance in EU countries on internal control is now concentrated.

By way of contrast, the final SEC rule on Section 404, issued on 5 June 2003, for reporting upon the effectiveness of internal control uses a much narrower definition of internal control (see 4.2.2), as it exclusively focuses on external financial reporting. The SEC defines internal control over financial reporting as:

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[14] Internal Control: Guidance for Directors on the Combined Code published by The Institute of Chartered Accountants in England & Wales (1999) (the Turnbull Report)

[15] Internal Control – Integrated Framework Committee of Sponsoring Organisations of the Treadway Commission (USA 1992)

[16] Guidance on Control published by the Canadian Institute of Chartered Accountants (1994)

[17] For the division of responsibilities between the management and the supervisory board a two-tier system see chapter 4.4.

“A process designed by, or under the supervision of, the registrant’s principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorisations of management and directors of the registrant; and
(3) Provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of the registrant’s assets that could have a material effect on the financial statements.”

4.2.1 Differing views on, and interpretation of, internal control

The various parties in the “triangle” of investors, boards and management, and external auditors may be interested in different aspects of internal control. Often these are referred to as the wider and narrow aspects of internal control.

The board of a company, its management and the company’s internal audit function should take a wider view of internal control. They are concerned with the management of all the significant risks facing a company, some of which may be directly related to financial reporting.

External auditors’ interest in internal control is primarily in the control systems that affect the financial reporting processes, which they will assess in order to form their opinion on the company’s financial statements. The International Auditing and Assurance Standards Board’s (IAASB) current document ISA 400 states that an internal control system means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. ISA 400 is however subject to revision. Proposed new standards are likely to widen the work of the external auditors in this area. Sections 7.2.4, 7.4 and 7.6 discuss how external auditors consider internal control as part of their audit.

Investors are likely not only to want to know that their company’s board has dealt with all the significant risks facing the company but they will also want assurance that the financial statements have been prepared from sound financial reporting processes. Investors may also want more information on the risks facing the company and how they are being, or will be, managed. They are therefore likely to desire assurance on both aspects of internal control.

The section 404 (Sarbanes-Oxley) approach to internal control only refers to financial reporting and is therefore very much narrower that that used in other guidance on internal control (CoCo, COSO and Turnbull).

The SEC recognises that internal control is a broad concept that extends beyond the accounting functions of a company. However, whilst agreeing that internal control objectives associated with enterprise risk management and corporate governance are important objectives, the definition that the SEC has adopted retains a focus on financial reporting in its final rule because:

- Section 404 focuses on the element of internal control that relates to financial reporting;
- Many commentators on the SEC's draft proposals indicated that even the limited definition related to financial reporting will impose substantial reporting and cost burdens on companies; and
- Independent auditors traditionally have not been responsible for reviewing and testing, or attesting to an assessment by management of, internal controls that are outside the boundary of financial reporting.

4.2.2 US - The Sarbanes-Oxley Act and the SEC's final rules

The SEC's final rules on section 404 of the Sarbanes-Oxley Act require a company's annual report to include an internal control report of management that, inter-alia, contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of, and a statement on, the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; and
- A statement that the external audit firm that audited the financial statements has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

Companies are requires to file, as part of the company's annual report, the attestation report from the external auditors.

Compliance commences for SEC domestic registrants as of the end of its first fiscal year ending on or after 15 June 2004. For foreign registrants/foreign private issuers (e.g. companies in EU Member States registered with the SEC) compliance commences as of the end of its first fiscal year ending on or after 15 April 2005.

Whilst accepting that COSO is a recognised framework, the SEC has also recognised that other frameworks exist outside the US that satisfy the intent of Sarbanes-Oxley without diminishing the benefits to investors. The SEC states that the Turnbull Report (UK) and CoCo (Canada) are examples of suitable frameworks that satisfy their criteria. However, they go on to say that the board of a foreign registrant company that relies on such a framework used in its home country is nevertheless under an obligation to state affirmatively whether the company's internal controls (presumably internal control for financial reporting) are, or are not, effective.

The SEC has added a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. However, as foreign registrants are not required to file quarterly reports then these companies need only disclose in their annual report the material changes to its internal control over financial reporting that have occurred in the period covered by the annual report.

The external auditor's attestation must be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board (PCAOB). Pending future developments, the PCAOB has currently adopted Statements on Standards for Attestation No. 10 (SSAE 10). Section 404 further stipulates that the attestation cannot be the subject of a separate engagement of the registered public accounting firm.

The Sarbanes-Oxley Act also introduces in Section 302 a new concept of "disclosure controls and procedures". These, which are to be evaluated for effectiveness and signed off by the CEO and CFO on a quarterly basis, covering the disclosure of information required under the Exchange Act reports (i.e. information filed with the SEC). SEC registered companies are thus introducing "disclosure committees" that are supported within the company by the necessary resources for reporting mechanisms. Disclosure controls are, however, not directly equivalent to the wider aspects of internal control.

Concerns about litigation appear to be high on the agenda of boards and management of SEC registered companies. Guidance prepared in the US on the internal control aspects of the Sarbanes-Oxley Act consistently refers to advice from legal counsel, or the work of disclosure committees in co-ordination with legal counsel. Care needs to be taken to ensure that legal concerns do not dominate the work on internal control leaving business benefit, which ultimately should benefit the investor, as a secondary consideration.

Introduction of all these additional, formalised requirements in the US will take time, much effort and additional costs. The transfer to these new requirements, most of which will require much formal paperwork for evaluations on a quarterly basis is an all pervasive change. It is not like a change in accounting policy.

4.2.3 EU - The Winter Group Report

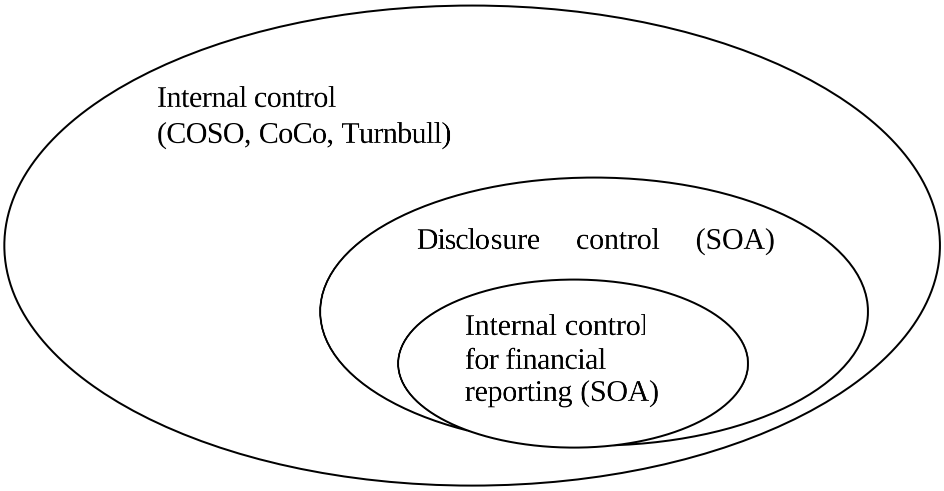
The Winter Group Report does not specifically refer to systems of internal control or refer to disclosure controls' but refers to the risk management system.

According to the Winter Group Report, the proposed annual corporate governance statement should include information on "the system of risk management applied by the company, describing the core strategy and activities of the company and the particular risks thereto. Where such a system does not exist, this must be disclosed." This recommendation is taken over by the Commission in its Communication on Company Law and Corporate Governance in that it requires disclosure by listed companies in the annual corporate governance statement of "the existence and nature of a risk management system".

The second, and more substantive reference by Winter to internal control, is in relation to the audit committee. It should:

- Monitor the company's internal audit procedures and its risk management system;
- Meet regularly with those who are responsible for the internal audit procedures and risk management system;
- Consider to what extent the findings of the risk management system should be reported in the company's financial statements.

4.2.4 Comments on these developments



Whilst the Winter Group refers to the risk management system, Sarbanes-Oxley (SOA) only considers internal control in relation to external financial reporting and the controls over information filed with the SEC. The diagram above illustrates that the Sarbanes-Oxley definition of internal control essentially represents a component of disclosure control and that disclosure control is a (relatively) small component of internal control as previously understood in COSO, CoCo and Turnbull. The Sarbanes-Oxley definition is not linked to obtaining benefits to the business from a review of the wider aspects of internal control and the related processes for risk management. The focus in the Sarbanes-Oxley Act on internal control related to financial reporting is commented upon in a US document published by the Conference Board[18]. This states that “many of the Act’s requirements deal specifically with financial reporting. Effective internal control systems should be designed to encompass all major areas of risk and vulnerability in a company’s operation, including corporate governance issues.”

Some EU Member States have gone beyond reporting on internal control for financial reporting purposes as required by Section 404 of Sarbanes-Oxley. For example, boards of UK listed companies are required to disclose in their annual reports information on the wider aspects of internal control, including their risk assessment procedures, disclose the processes that they have adopted to review the effectiveness of internal control, and state that the work that the board has undertaken is in accordance with the guidance in the Turnbull Report. It is pleasing to note that the SEC in its final rule accepts that the Turnbull report (along with COSO and CoCo) meets its criteria for the establishment of a suitable framework.

It is important to embed risk management into a business. FEE is concerned that the Sarbanes-Oxley approach will focus businesses on a formal exercise and away from a wider assessment of risk management which can yield greater business benefits.

It is interesting to note that commentators to the SEC’s draft proposals on the narrow definition of internal financial control were concerned about the imposition of substantial reporting and cost burdens on companies.

[18] The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations (January 2003)

An overall objective for the EU should be to try to keep requirements simple. Whilst internal control is fundamental to every business and should be part of its culture and processes; every effort should be taken to avoid creating bureaucratic and costly mechanisms in the production of information that could be better used in generating shareholder value. A balanced approach is needed to ensure that whilst costs need to be expended to ensure that internal control and risk management "thinking" is properly embedded in the culture of the organisation along with regular reporting and information flows.

FEE supports the consideration of wider aspects of internal control as risk can have significant impact on the company's financial results and statements. FEE is at present undertaking a project on internal control which aims to develop a position on how directors and auditors can responsibly report on companies' systems of internal control in ways that serve the public interest. There is a clear need for guidance in this area.

4.3 Challenges and problems associated with internal control

4.3.1 The issues of "effectiveness" reporting and false assumptions about systems of internal control

Internal control is a complex concept and easily misunderstood. In sections 4.1 and 4.2 it is shown that internal control means different things to different people and in different countries.

Public external reporting presents difficulties because any consideration of effectiveness must include assessment of inter-relationships, intangible concepts and subjective judgements on matters such as corporate culture.

Section 404 of the Sarbanes-Oxley Act requires management to provide an internal control report as to the effectiveness of the internal control structure and procedures for financial reporting. It also requires an attestation statement from the external auditor.

There is not yet, however, clarity or consensus as to what constitutes "effectiveness". It is an often used word that cannot easily be defined. For example, to some users of financial statements, "effectiveness" could imply that controls can offer absolute assurance against misstatement or loss. Suitable criteria for evaluating effectiveness which are transportable across different companies have not yet been developed. Effectiveness is a relative concept and scoring mechanisms do not yet exist which allow one company, or even one process or team in a company, to be benchmarked against another.

While assessment of the effectiveness of internal control in enterprises for internal purposes should be encouraged, external reporting on the effectiveness of internal control presents considerable challenges and should be subject for further discussion and exploration. Public reporting of weaknesses in internal controls may present reputational risks to a company and may undermine the viability of the company, particularly companies in the financial services industry. Anything less than a clean bill of health could be harmful for the company. There are few companies that are not capable of improvement in some parts of their internal control systems. The discussion should provide clarity on what is meant by internal control; there should be realism on what internal control can and cannot do and how it can be assessed and reported upon. It should be remembered that the directors of a company could report only on their own processes for reviewing the effectiveness of the company's systems of internal control without getting into the more difficult area (for both boards and auditors) of reporting whether the company's controls are effective. Part of the discussion will be on internal controls in relation to financial reporting. A distinction should also be made between reporting by directors and reporting by the external auditor. The issue should be considered in the light of the existing experience in Europe and the practical experience that is likely to become available in the US.

The Cadbury Committee recommended that boards report on the effectiveness of the system of internal control but recognised that a means for assessment did not at that time (1992) exist. Although considerable effort went into considering how to report on the effectiveness of internal control, no satisfactory solution emerged and Hampel omitted the recommendation when proposing the Combined Code. The Turnbull guidance in 1999 set out how boards should review all aspects of internal control and report publicly on their review but stopped short of a requirement to report on effectiveness. Throughout the process the emphasis was on the directors' process for being satisfied that control was effective rather than direct reporting that it was effective. In Italy the board of statutory auditors of listed companies has to declare, in its annual report to the shareholders' meeting, that it has checked the adequacy of the company's organisational structure for the matters within the scope of the board's authority, the internal control system and the administrative and accounting system as well as the reliability of the latter in correctly representing the company's transactions. The accounting profession has issued guidelines in order to comply with this task. The guidelines include requiring from executives a self-evaluation report: this report is, normally, not published. In France under the draft law on financial security both the management board and the auditor are required specifically to report on internal control. A professional standard is now under consideration by CNCC.

FEE therefore recommends that further research and exploration is required with regard to the criteria for assessing the effectiveness of internal controls and is currently undertaking a project on internal control.

Matters that, among others, may be considered by the FEE project on internal control in the respective countries

1. Different levels of internal control. In literature it has been suggested that different levels of internal control can be identified. The highest level of control is the governance function of the board. The next level is senior management which is responsible for controlling the organisation. The third level is the management systems that assist management in controlling its activities, including financial reporting systems. The lowest level of internal controls are the components of management systems such as documentation practices. The issues here include (1) by focusing on the lowest level of internal controls, the bigger picture could be missed and (2) difficulties of reporting and assessing of internal controls may differ in relation to the level of internal control.

2. The informal aspects of internal control. These aspects are important and essentially mean the control environment (see 4.5) and include such matters as culture, commitment, ethics and communication. COSO states that the effectiveness of internal controls cannot rise above the ethical values of the people who create, administer and monitor them. It has been suggested that most, if not all, major corporate governance failures are a result of weaknesses in the control environment. Obviously it is therefore harder, if not impossible, for management to assess and report meaningfully on the "operation" or effectiveness of other components of control, in particular the control environment, and harder still for auditors to attest.

3. Possible forms of reporting on internal control. Boards in some jurisdictions are at present requested to make a statement on their review of internal control and auditors have to report upon this statement. FEE emphasises that the main benefit in reviewing internal control is not to report upon an arbitrary assessment of effectiveness but to assess, reflect and respond to risks to achieving objectives so as to improve a business's ability to meet its objectives. What is "effective" for one company may be insufficient for another, or totally excessive and unnecessary for a third company. Therefore will the information provided to investors regarding effectiveness be of any meaningful use? Benchmarking of systems of internal control against forms of pre-determined standards presents considerable difficulty.

4.3.2 Internal control and fraud and error

No system of control is proof against human error or deliberate override. Nor can a system of internal control eliminate the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.

A sound system of internal control provides reasonable assurance that a company will not be hindered in achieving its business objectives, including reliable financial reporting, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations.

4.4 Responsibility of management and the (supervisory) board for internal control

In a unitary board system the responsibilities for the establishment, maintenance and monitoring of internal controls lies with the entire board. In a two-tier system these responsibilities are divided between the management board and the supervisory board. The respective responsibilities of both boards may vary between countries having adopted a two-tier system. For example, in Germany or Austria, the establishment and maintenance of the internal controls is a responsibility of the management board, whereas the supervisory board has to monitor whether the management board fulfils its duties and ensure that the established internal controls are appropriate and effective.

As the risks facing a company are continually changing, the board should ensure a thorough and regular assessment of the risks to the company and the controls to manage them.

A company's (management) board should therefore adopt a risk-based approach to establishing a sound system of internal control and for the (supervisory) board's review of its effectiveness. This approach should be incorporated by the company within its normal management and governance processes.

When considering information during the year, the board should:

- Consider what are the significant risks (relevant risks may not necessarily be of a financial nature, for example operational, environmental, social and reputation risks) and assess how they have been identified, evaluated and managed;
- Assess the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
- Consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- Consider whether the findings indicate a need for more extensive monitoring of the system of internal control.

Boards should determine the level of formality required for documenting and reviewing systems of risk management and internal control and provide sound appropriately documented support for its statement on internal control. The amount of documentation may be affected by the board's assessment of the control environment/culture within the company.

Having an appropriate degree of formality, especially relating to the documentation, will enable the relevant reports to be made by management and will enable the appropriate level of review of the process to be made by third parties, such as the external auditors.

4.5 Control environment

4.5.1 The control environment and responsibility for systems of internal control

The board supported by senior management have to set the right control environment.

COSO states that official policies and procedures describe what management want to happen and culture determines what actually happens and which rules are obeyed, bent or ignored.

According to COSO, the control environment sets the tone of an organisation, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include integrity, ethical values and competence of a company's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organises its people; and the attention and direction provided by the board.

Therefore, within any company, be it under either the unitary or two-tier board system, the control environment reflects the overall attitude, awareness and actions of the entire board and senior management concerning the importance of control. Corporate culture will influence the way in which:

- Business activities are structured,
- Objectives are established, and
- Risks are assessed.

Specifically, from a financial reporting perspective, the control environment is vitally important because it is within this culture that the financial reporting processes take place. Corporate culture here will influence:

- The way in which financial statements are prepared (its financial reporting philosophy);
- Management's attitude towards accounting estimates and the aggressiveness (or not) of the company's accounting policies; and
- The company's accounting systems and controls.

The control environment will also influence all other aspects of internal control activities and monitoring processes. Events at Enron and WorldCom highlighted that time spent on numerous and detailed internal procedures will not be of much significance if the control environment is lax, ineffective or if the board/senior management are seen to be willing to cut corners or take an aggressive stance.

4.5.2 Code of ethics

Integrity and ethics are key elements of the control environment, which like many other elements of internal control, are difficult to measure.

In the context of financial reporting, both the board and the company's auditors should be objective in fulfilling their tasks. Objectivity[19] is a relative concept. A simple but imperfect definition in a wider context is that objectivity is a state of mind where decisions are made and acted upon with regard to all considerations relevant to the task in hand but excluding considerations influenced by prejudice, bias, conflict of interest or undue influence of others; it presupposes intellectual honesty. All directors should act in accordance with the company's best interest.

4.5.3 Assessment of the control environment and ethics

It is important to assess the control environment. This cannot only be done by a checklist. It requires reflective thought by directors, managers and staff.

In any organisation, the leaders are responsible for setting the ethical tone and leading by example. Boards should ensure that the company has an ethical code and that they and their staff understand and apply it. Having a code is of no value unless it is observed.

Boards can show their commitment to the control environment and to ethics, by involving themselves and their staff in a self-assessment programme. Such a programme could include processes to allow concerns to be voiced by employees, consider the extent to which staff follow both the spirit and the letter of the code and encourage and facilitate improvement in ethical performance. As a means to aid assessment, companies can use a framework, which might consider issues such as leadership, staff, external relations including society, internal relations including communication and culture and the company's code of conduct.

The recent US corporate debacles revealed the risks where staff are prevented, through fear of reprisal, from raising matters of concern. Management and staff need to feel free to talk about concerns without fear of reprisal. The (supervisory) board should ensure that management creates a supportive environment for this communication to occur.

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[19] A definition of "objectivity" is provided in the FEE Study "Statutory Audit Independence and Objectivity – Common Core of Principles for the Guidance of the European Profession – Initial Recommendations" of 1998.

Workshops can be used to consider the effectiveness of control environment, other aspects of internal control and to consider ethics. Workshops can identify problems and their causes and produce solutions. Workshops are particularly useful for assessing informal control - an area where traditional audit methods are relatively weak.

Many companies now run workshops to consider ethical behaviour. This would be appropriate for all companies "to stimulate" a culture where people are not too inhibited from speaking is required. Commitment from the top of the organisation to listen to what staff tell them is also needed.

<u>Recommendations</u>

4.1 Boards should consider the wider aspects of internal control as risk can have significant impact on the company's financial results and statements. FEE is at present undertaking a new project on internal control with as aim to develop a position on how directors and auditors can responsibly report on companies' systems of internal control in ways that serve the public interest. There is a clear need for guidance in this area.

4.2 In any organisation, the leaders are responsible for setting the ethical tone and leading by example. Boards should ensure that the company has an ethical code and that they and their staff understand and apply it.

4.3 Management and staff need to feel free to talk about concerns without fear of reprisal. The (supervisory) board should ensure that management creates a supportive environment for this communication to occur.

4.4 A company's (management) board should adopt a risk-based approach to establishing a sound system of internal control and for the (supervisory) board's review of its effectiveness. This approach should be incorporated by the company within its normal management and governance processes.

4.5 While assessment of the effectiveness of internal control in enterprises for internal purposes should be encouraged, external reporting on the effectiveness of internal control presents considerable challenges and should be subject for further discussion and exploration. Public reporting of weaknesses in internal controls may present reputational risks to a company and may undermine the viability of the company, particularly companies in the financial services industry. Anything less than a clean bill of health could be harmful for the company. There are few companies that are not capable of improvement in some parts of their internal control systems. The discussion should provide clarity on what is meant by internal control; there should be realism on what internal control can and cannot do and how it can be assessed and reported upon. It should be remembered that the directors of a company could report only on their own processes for reviewing the effectiveness of the company's systems of internal control without getting into the more difficult area (for both boards and auditors) of reporting whether the company's controls are effective. Part of the discussion will be on internal controls in relation to financial reporting. A distinction should also be made between reporting by directors and reporting by the external auditor. The issue should be considered in the light of the existing experience in Europe and the practical experience that is likely to become available in the US.

4.6 FEE therefore recommends that further research and exploration is required with regard to the criteria for assessing the effectiveness of internal controls and is currently undertaking a new project on internal control.

5 INTERNAL AUDIT

An effective internal audit function can play a significant role within the corporate governance framework of a company.

5.1 Role of internal audit

Over the last decade internal audit has developed and grown in importance. This development has been in parallel with the change in emphasis towards the wider aspects of internal control focusing on a risk-based approach, generally with less emphasis on internal financial control. Leading edge internal audit functions provide objective assurance/assessments to the board (and to the audit committee) about the adequacy and effectiveness of the processes by which risks are identified and prioritised; managed, controlled, and mitigated.

In most countries and business sectors internal audit reports professionally to an audit committee and managerially to the chief executive or chief financial officer. In other countries internal audit reports both professionally and managerially to management rather than to non-executive directors or supervisory board members.

Internal audit is an independent and objective appraisal function; it supports senior management and the (management) board. Their responsibilities and the reporting lines vary between unitary and two-tier systems and between countries with a two-tier system (see chapter 4.4). For example, in Germany the internal audit department fulfils a support function for the management board without involvement of the supervisory board, whereas in Denmark the internal audit reports directly to the supervisory board, is hired and can only be dismissed by decision in the supervisory board[20]. In most countries with a unitary board system, as a support function for a board and its audit committee, the remit of a company's internal audit function is agreed upon by the board in conjunction with its audit committee.

The remit of internal audit is therefore both company and country specific. Nevertheless, whilst acknowledging the importance of internal financial control in the current environment where there is a need to improve confidence in financial reporting, FEE recommends that the remit of internal audit functions should continue to have a significant focus on assessing the wider aspects of internal control which are linked to the management of risks facing a company.

Internal audit activities are performed in diverse legal and cultural environments; within organisations that vary in size and structure. Internal audit functions should comply with the relevant professional standards (such as the *Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors).

5.2 The internal audit function and its reporting relationships with the audit committee and management

The role of the audit committee with regard to the internal audit function also differs depending on the established division of responsibilities within the governance structure. Depending on the role of internal audit in the specific governance structure, the internal audit function either reports professionally to management or is independent in its reporting from the management.

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[20] According to Danish legislation regarding financial institutions.

The differences referred to in 5.1 affect the reporting relationships of internal audit more than its function. Internal audit will normally address its draft reports to the manager of the function being audited (the auditee) to give the auditee the opportunity to correct any factual errors or misunderstanding before a report is finalised and then sent, with appropriate levels of detail, to the audit committee, and relevant senior management.

Where the internal audit function is not under direct control of management (which is the case in many Member States), the internal audit function should have an independent professional reporting line directly to the audit committee with the Head of Internal Audit normally invited to attend its meetings. This reporting line assists the internal audit function in maintaining its objectivity by being able to communicate the results of its work to the audit committee without interference from management. The audit committee should monitor and review the activities and effectiveness of the internal audit function and should review and approve the internal audit function's remit. The audit committee will need to decide if, and how, internal audit and external audit should work together, bearing in mind the different roles of each of the two audit functions (see section 5.5). The audit committee should approve the appointment of the Head of Internal Audit. It should also consider the resignation or approve the termination of appointment of the Head of Internal Audit after sufficient enquiry to be satisfied with the reasons for resignation and termination.

In its review of the work of the internal audit function, the audit committee should, inter alia:

- Ensure that the Head of Internal Audit has direct access to the chairman of the board/supervisory board as well as to the audit committee;
- Ensure that the internal audit function is professionally accountable to the audit committee;
- Review and assess the internal audit work plans;
- Receive regular reports on the execution of the internal audit function's work plans and an annual report from the internal audit function;
- Review and monitor management's responsiveness to the findings and recommendations of the internal audit function;
- Meet the Head of Internal Audit at least once a year without the presence of management; and
- Monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.

Where there is no internal audit function and the internal audit function would not form part of management, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board. Reasons for the absence of an internal audit function should be explained in the corporate governance section of the annual report.

FEE recommends that all the above are minimum requirements to be included in an audit committee's own terms of reference, in case of an internal audit function independent from management.

In other countries, such as Austria and Germany, internal audit will report only to the management board because constitutionally it has a support function to the management board. In such situations FEE believes it would be good practice for supervisory board members to receive a summary of the audit work carried out and its findings and have the opportunity to put questions to the Head of Internal Audit. FEE also suggests that the supervisory board considers how it receives satisfactory assurance that internal audit is adequately carrying out its independent and objective appraisal function.

5.3 Resources for the internal audit function

A key feature of the expanding role, and increasing expectations, of an internal audit function is the resources and skills base to which it has access. Inevitably this impacts on the budget allocated to the internal audit function.

FEE believes that the body within the company responsible for agreeing upon the remit of the internal audit function (such as the audit committee) should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and that it is equipped to perform in accordance with appropriate professional standards for internal auditors.

5.4 Independence and objectivity of internal audit

Boards, audit committees, and senior management should recognise the great value to the company of the internal auditors' knowledge of the company and its processes, and their skills in:

- Systematically analysing a process;
- Applying objective judgement to assess its effectiveness; and
- Independently/objectively reporting on findings and making recommendations to improve the effectiveness of that process.

However, to ensure that boards and audit committees receive this value from its internal audit function, the internal auditors must not be hindered by management in suppressing reports.

Outsourcing of all, or part of, the internal audit function to the current external auditor is dealt with by the Commission's Recommendation on Auditor Independence[21]. This does not however prevent an audit committee from outsourcing to another external auditor. Because of independence issues, the external auditor should not take the full responsibility for internal audit.

5.5 The roles of external and internal audit

Maximisation of the effectiveness of the company's two audit functions is a priority for the board/supervisory board and the audit committee. This can be helped by:

- A good dialogue and understanding between the two audit functions; and
- A recognition that the two functions have differing responsibilities and very often a different scope of work.

It is important for all parties to recognise that the roles, responsibilities and objectives of internal audit and external audit are different. These can be summarised as follows:

[21]Commission Recommendation "Statutory Auditors' Independence in the EU: A Set of Fundamental Principles" (May 2002)

External Audit

- Is elected by the shareholders;
- By means of the auditor's report the auditor reports to shareholders and in some countries to other stakeholders;
- Provides an independent opinion on the company's financial statements drawn up to a point in time;
- Reports to the (supervisory) board/ and the audit committee those material weaknesses in accounting and related internal control systems that come to his attention during his external audit work;
- Has to consider standards for financial reporting and related requirements; and
- Complies with auditing standards issued by the relevant standard setting body.

Internal Audit

- Is a service to the company focusing on the risk and control framework and processes;
- Its scope of work and responsibilities are determined by the board and the audit committee within the company and can vary depending upon the size, structure and complexity of the company and the resources allocated;
- Takes a wider view of risk and control than the external auditors;
- Should adhere to professional standards relevant to the conduct of its work; and
- Where the internal auditor is independent from management, has an internal reporting line to the (supervisory) board and/or the audit committee.

The external auditor may be able to rely, where possible and relevant, upon the internal audit function where both undertake work in the same domain depending on the external auditor's assessment of whether the work of the internal audit is adequate for external audit purposes. This requires good communication between the two sets of auditors, and co-ordination.

Although consultation and working with the external auditors may be a part of the remit, it is not the role of internal audit to be used by management to manage the cost of external audit. While recognising the importance of internal financial control, the audit committee should understand the implications, especially if there are scarce resources for an internal audit function and because their work priorities, as assigned by the board, differ from those of the external auditors.

5.6 The work of an internal audit function

The work of the internal audit function should not be significantly affected by any national differences in the reporting process, as described before.

The internal audit function should consider significant exposures to risk and assist the board and senior management to maintain effective control by evaluating the company's response to risk and by promoting continuous improvement in the effectiveness and efficiency of operations.

As part of its consideration of the control environment, internal audit should consider control over:

- Reliability and integrity of financial and operational information,
- Effectiveness and efficiency of operations,
- Safeguarding of assets,
- Compliance with laws, regulations, and contractual requirements.

Internal auditors should ascertain the extent to which management has established suitable criteria to determine whether objectives are being achieved. If adequate, internal auditors should use such criteria in their work. If inadequate, internal auditors should work, while maintaining their objectivity, with management, and other bodies as appropriate, to develop evaluation criteria that are appropriate to the specific circumstances of the company.

Recommendations

5.1 Whilst acknowledging the importance of internal financial control in the current environment where there is a need to improve confidence in financial reporting, FEE recommends that the remit of internal audit functions should continue to have a significant focus on assessing the wider aspects of internal control which are linked to the management of risks facing a company.

5.2 Where the internal audit function is not under the direct control from management:

- The internal audit function should have an independent professional reporting line directly to the audit committee with the Head of Internal Audit normally invited to attend its meetings. This reporting line assists the internal audit function in maintaining its objectivity by being able to communicate the results of its work to the audit committee without interference from management.

- The audit committee should monitor and review the activities and effectiveness of the internal audit function and should review and approve the internal audit function's remit. The audit committee will need to decide if, and how, internal audit and external audit should work together, bearing in mind the different roles of each of the two audit functions.

- The audit committee should approve the appointment of the Head of Internal Audit. It should also consider the resignation or approve the termination of appointment of the Head of Internal Audit after sufficient enquiry to be satisfied with the reasons for resignation and termination.

- The audit committee, in its review of the work of the internal audit function, should, inter alia:

  - Ensure that the Head of Internal Audit has direct access to the chairman of the board/supervisory board as well as to the audit committee;
  - Ensure that the internal audit function is professionally accountable to the audit committee;
  - Review and assess the internal audit work plans;
  - Receive regular reports on the execution of the internal audit function's work plans and an annual report from the internal audit function;
  - Review and monitor management's responsiveness to the findings and recommendations of the internal audit function;

- Meet the Head of Internal Audit at least once a year without the presence of management; and
- Monitor and assess the role and effectiveness of the internal audit function in the overall context of the company 's risk management system.

5.3 Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board. Reasons for the absence of an internal audit function should be explained in the corporate governance section of the annual report.

5.4 In other countries internal audit will report only to the management board because constitutionally it has a support function to the management board. In such situations FEE believes it would be good practice for supervisory board members to receive a summary of the audit work carried out and its findings and have the opportunity to put questions to the Head of Internal Audit. FEE also suggests that the supervisory board considers how it receives satisfactory assurance that internal audit is adequately carrying out its independent and objective appraisal function.

5.5 FEE believes that the body within the company responsible for agreeing upon the remit of the internal audit function (such as the audit committee) should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and that it is equipped to perform in accordance with appropriate professional standards for internal auditors.

5.6 The internal audit function should consider significant exposures to risk and assist the board and senior management to maintain effective control by evaluating the company's response to risk and by promoting continuous improvement in the effectiveness and efficiency of operations.

5.7 Internal auditors should ascertain the extent to which management has established suitable criteria to determine whether objectives are being achieved. If adequate, internal auditors should use such criteria in their work. If inadequate, internal auditors should work with management to develop evaluation criteria that are appropriate to the specific circumstances of the company.

6 DISCLOSURE ABOUT CORPORATE GOVERNANCE

6.1 General disclosure

Improving disclosure about corporate governance to shareholders is one way of empowering shareholders to play a greater role in the governance of their company. Other stakeholders may also be interested in the company's corporate governance.

FEE agrees with the Winter Group and the Commission's Communication on Company Law and Corporate Governance that disclosure is a powerful tool to improve corporate governance. FEE therefore supports the recommendation to require companies to make a comprehensive corporate governance statement in their annual reports. Responsibility for such a statement should rest with the board, which in a two-tier system means both the management and the supervisory boards.

According to the Winter Group and Commission's Communication, listed companies should be required to publish a coherent and descriptive statement covering the key elements of their corporate governance structure and practices they apply, regardless of whether these elements arise from mandatory law, default provisions, articles of association, resolutions of company organs, codes or other company processes. The Commission has followed the Winter Group recommendations in their Communication and has further detailed them as follows:

- The operation of the shareholders meeting and its key powers, and the description of shareholder rights and how they can be exercised;
- The composition and operation of the board and its committees[22];
- The shareholders holding major holdings, and their voting and control rights as well as key agreements;
- The other direct and indirect relationships between these major shareholders and the company;
- Any material transactions with other related parties;
- The existence and nature of a risk management system; and
- A reference to a national code on corporate governance with which the company complies or in relation to which it explains deviations.

FEE welcomes the intention of the Commission to issue in the short term a proposal for a Directive containing the principles applicable to such an annual corporate governance statement.

The Winter Group and the Commission combine two complementary approaches for reporting on corporate governance structures of a company:

- The "descriptive approach" requiring a narrative description of the corporate governance structure implemented within the reporting company and of how the company has applied defined corporate governance principles; and
- The "comply or explain" approach requiring a statement whether the reporting company has observed the applicable (national) corporate governance code and, in case of (partial) non-compliance, why and to what extent the provisions of the respective corporate governance code were not complied with.

[22] In this respect, it is considered essential for the restoration of public confidence that proper information is given on the way in which the company has organised itself at the highest level to establish and maintain an effective internal control system.

The advantage of a description of corporate governance is that it can be adapted to the individual enterprise to meet information needs of its shareholders, and relevant stakeholders. However, this approach may be in conflict with the objective of enhancing comparability of corporate governance statements and not allow the reader to assess the completeness of the information provided as well as the balance, i.e. the freedom from bias. Therefore, such a narrative statement needs to be accompanied with a compliance statement, which can significantly increase clarity for the reader. Comparability will be further improved if companies use a common framework for corporate governance reporting.

FEE sees the need for an agreed framework for corporate governance reporting setting out common principles on the form and content of such reports. While considerable progress has been made in identifying the core issues to be reported, little progress has been made in establishing the conceptual underpinning that any form of public reporting requires. FEE would be willing to work with other parties to develop such a conceptual framework.

The narrative corporate governance statement might include the following issues in addition to those mentioned by the Winter Group and in the Commission's Communication:

- Discussion of the company's objectives and progress in achieving them;
- Comment on strengths and resources of the business in relation to its objectives;
- Comment on significant changes in operating performance and what has influenced these changes;
- Comment on the identified main risks and uncertainties affecting the company;
- Comment on how the potential impacts of risks are managed;
- Comment on how directors will aim to improve operational performance of the company; and
- Report by the audit, remuneration and nomination committees on their activities.

When deciding on the content of a narrative corporate governance statement, there must be a clear distinction with the contents of the management report defined in Article 46 of the Fourth Directive and Article 36 of the Seventh Directive. According to the directive modernising and updating especially the Fourth and the Seventh Directives, Article 46.1 of the Fourth Directive and Article 36 of the Seventh Directive reads as follows:

"1. (a) The annual report shall include at least 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 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;

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

These revised provisions cover a number of the items including the suggestion of the Winter Group with respect to the "system of risk management applied by the company, describing the core strategy and activities of the company and the particular risks related thereto".

As financial reporting and corporate governance overlap there could be uncertainty whether to disclose certain matters in the financial statements and in the directors' report or in a corporate governance statement. It would therefore be desirable for countries to move towards a consensus on where new disclosure items should appear.

The interests of minority shareholders must be protected. It is therefore vital that all shareholders receive information equally. All disclosures relating to financial and non-financial performance and corporate governance should be timely and made available to all shareholders at the same time. The timeliness and equality of disclosure should be monitored by the (supervisory) board. It is important to get information (good and bad) to the market with a minimum delay and in such a way that, as far as possible, information which may have a material impact on share prices is made available to all investors and traders at the same time.

6.2 Internal control disclosures and reporting

Internal control disclosure is part of a larger framework of disclosure of corporate governance performance.

It is clear that much remains to be resolved about assessing and reporting on internal control. The overriding principle should be that disclosure is useful to shareholders and – in some countries – to other relevant stakeholders. While a "comply or explain" basis may be appropriate for reporting on other aspects of corporate governance performance, FEE believes that there should be some qualitative information about the processes that boards have undertaken to manage risk and assess internal control. Internal control disclosure will form part of the project FEE is currently undertaking (section 4.3.1). In this context the following issues could be discussed:

- Should the (management) board issue a statement that it has reviewed all the significant risks facing the company, how it conducted its review, and that the external auditors have reviewed the board's statement?
- Is it more important to have an approach to internal control that (a) stimulates meticulous documentation and controls that creates a "tick-box" approach or (b) requires the (management) board to work through a thoughtful and reflective review process before making their statements on internal control?
- Would shareholders and other stakeholders be more interested in risk reporting that gives them increased information and a better understanding of the risks facing the company, rather than trying to benchmark a system of internal control?
- Do investors and other addressees/stakeholders agree that, whilst important, internal control should not be looked at solely from the viewpoint of financial reporting?

Even if the company has a risk committee (which is often made up of management and not solely non-executive directors), the audit committee should help the board in assessing the work and output of the risk committee and in reviewing any statement made by the board in its annual report on the effectiveness of the systems of internal control.

Addressees of internal control disclosure may be assured if they know that a board is required to undertake a rigorous process for the review of risk management and internal control in order to make their report on internal controls as part of the corporate governance statement. Issues to be addressed would include:

- Whether (management) boards of companies have followed a framework process endorsed by a relevant regulatory authority; and
- Whether the (management) board's statement needs to be reviewed by the external auditors.

These questions will also be addressed in FEE new internal control project (see chapter 4).

6.3 Reporting to shareholders on the activities of the audit committee

FEE recommends that information on the audit committee's responsibilities and activities should be provided as a part of the board's corporate governance statement. This will improve transparency, promote a better understanding of the work of the audit committee and help to reduce possible expectation gaps. Additional information could be included on a special page devoted to the audit committee on the company's website.

Listed below are some key headings upon which information could be provided:

- Role, responsibilities and authority of the audit committee,
- Key activities of the audit committee,
- Membership, resources and training of the audit committee,
- Self-assessment and terms of reference of the audit committee.

There is no "one size fits all" solution and audit committees are encouraged to go beyond basic information and provide more details on the committee's web page on the company's website. The information that a committee provides will depend, inter-alia, on its terms of reference.

<u>Recommendations</u>

6.1 FEE agrees with the Winter Group and the Commission's Communication on Company Law and Corporate Governance that disclosure is a powerful tool to improve corporate governance. FEE supports the recommendation to require companies to make a comprehensive corporate governance statement in their annual reports. Responsibility for such a statement should rest with the board, which in a two-tier system means both the management and the supervisory boards.

6.2 FEE sees the need for an agreed framework for corporate governance reporting setting out common principles on the form and content of such reports. While considerable progress has been made in identifying the core issues to be reported, little progress has been made in establishing the conceptual underpinning that any form of public reporting requires. FEE would be willing to work with other parties to develop such a conceptual framework.

6.3 As financial reporting and corporate governance reporting overlap there could be uncertainty whether to disclose certain matters in the financial statements and in the director's report or in a corporate governance report. It would therefore be desirable for countries to move towards a consensus on where new disclosure items should appear.

6.4 The interests of minority shareholders must be protected. It is therefore vital that all shareholders receive information equally. All disclosures relating to financial and non-financial performance and corporate governance should be timely and made available to all shareholders at the same time. The timeliness and equality of disclosure should be monitored by the (supervisory) board.

6.5 FEE believes that both shareholders and other relevant stakeholders require qualitative information about the processes that boards have undertaken to manage risk and assess internal control.

6.6 FEE recommends that the information on the audit committee’s responsibilities and activities should be provided as a part of the board’s corporate governance statement. This will improve transparency, promote a better understanding of the work of the audit committee and help to reduce possible expectation gaps. Additional information could be included on a special page devoted to the audit committee on the company’s website.

7 EXTERNAL AUDIT

7.1 Role of the external auditor of financial statements

The external auditor has a central role not only in application of accounting standards (see 2.5) but also in the wider corporate governance system. Within this role the external auditor fulfils the following functions:

(a) *Attestation function in the public interest*

By means of the external auditor's report the auditor informs shareholders and, where applicable, other users of financial statements whether and to what extent, in the auditor's opinion, the audited financial statements give a true and fair view and comply with the applicable accounting standards. Thereby, the external auditor contributes to the reliability of financial reporting as one major source of information for shareholders and other stakeholders about the economic situation of the reporting company.

The relative importance of stakeholders vs shareholders varies in the different corporate governance structures and cultures and is relevant for answering the question to whom the auditor addresses his report. This varies across Europe from reporting only to shareholders to reporting to the public in general. This difference in reporting can have an impact on the liability of the auditor (to which parties the auditor is liable and whether any liability is limited).

(b) *Supportive function for non-executives/supervisory board*

In addition to issuing an auditor's report addressed to shareholders (and, in some countries, to the public), the external auditor is required to communicate his or her audit findings to those bodies within the audited company which are entrusted with the supervision and monitoring of the company. The auditor supports NEDs and audit committees in fulfilling their own tasks by communicating matters relevant to overseeing financial reporting and disclosure and relevant to supervising the audited company that come to the auditor's attention during the audit.

(c) *Preventive function in relation to proper application of accounting standards by management*

The external auditor has a deterrent influence which improves the quality of financial reporting in two ways. First, the requirement for an audit of financial statements enhances the management's efforts to prepare high quality financial statements. Second, given the public impact of an auditor's report, the threat of a qualified or adverse audit opinion prompts management to correct misstatements in the financial statements discovered by the auditor before the auditor expresses his audit opinion. For these reasons it is rare for the audit opinion to be qualified.

As pointed out in the introduction there are interdependencies between the role of the auditor and the NEDs as a key part of the corporate governance framework. An effective audit assists the NEDs to successfully carry out their tasks and the audit benefits from a strong involvement and interaction with the NEDs in improved input on understanding of relevant business issues and reduction of control risk. The next section provides a high level understanding of the external audit process in order to allow for an informed discussion of the relevance of the external audit to the effectiveness of corporate governance.

7.2 The audit process

In order to understand how the external audit interacts with the wider aspects of corporate governance it is important to gain an overall understanding of the audit process, its objectives, focus and conceptual framework. International Standards on Auditing (ISAs) developed by the International Auditing and Assurance Standards Boards (IAASB) have been adopted as the basis for performing audits in most Member States throughout the EU. The following summary of the audit process and its conceptual framework is based on ISAs. This description is based on the existing ISA and Framework as laid down in ISA 100. At present the Framework is under review. An Exposure Draft on Assurance Engagements was issued in March 2003. The audit risk model is also under review and may substantially change.

7.2.1 Objective of an audit

The objective of a external audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework (e.g. International Financial Reporting Standards – IFRS) in respect to the financial statements. The phrase commonly used to express the external auditor's opinion is "give a true and fair view of the financial position of the Company as of December 31, 20XX, and of the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards."

The auditor should plan and perform the audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of the documents or management representations. In planning and performing the audit, the auditor neither assumes that management is dishonest nor assumes unquestionable honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on the base the audit opinion.

An audit performed in accordance with generally accepted auditing standards (ISAs) is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatements. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole.

However, there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as the use of testing, the inherent limitations of any accounting and internal control system (for example, the possibility of collusion) and the fact that most audit evidence is persuasive rather than conclusive.

7.2.2 Audit evidence

The auditor should obtain sufficient appropriate evidence to be able to draw reasonable conclusions on which to base the audit opinion. Audit evidence is obtained from an appropriate mix of tests of control and substantive procedures. In some circumstances, evidence may be obtained entirely from substantive procedures. Test of controls means tests performed to obtain audit evidence about the suitability of design and effective operation of the accounting and internal control systems. Substantive procedures means tests performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types: test of details of transactions and balances; and analytical procedures.

When obtaining audit evidence from substantive procedures, the auditor should consider the sufficiency and appropriateness of audit evidence from such procedures together with any evidence from tests of controls to support financial statement assertions. Financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements. They can be categorised as follows:

(a) *Existence*: an asset or a liability exists at a given date;
(b) *Rights and obligations*: an asset or a liability pertains to the entity at a given date;
(c) *Occurrence*: a transaction or event took place which pertains to the entity during the period;
(d) *Completeness*: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
(e) *Valuation*: an asset or liability is recorded at an appropriate carrying value;
(f) *Measurement*: a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
(g) *Presentation and disclosure*: an item is disclosed, classified, and described in accordance with the applicable financial reporting framework.

The auditor obtains audit evidence by one or more of the following procedures: inspection, observation, inquiry and confirmation, computation and analytical procedures.

7.2.3 Materiality and risk

The auditor should consider materiality and its relationship with audit risk when conducting an audit. Information is material if its omission or misstatement could influence the economic decisions of the relevant users taken on the basis of the financial statements.

In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.

Materiality is considered by the auditor when determining the nature, timing and extent of audit procedures and when evaluating the effect of misstatements.

Risk is fundamental to the audit process. The audit defines the overall risk ("audit risk") as the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. The audit risk consists of three components: inherent risk, control risk and detection risk. Inherent risk is the susceptibility of an account balance or class of transactions to misstatements that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk is the risk that a misstatement (e.g. that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes) will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems. Detection risk is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk to accept for the financial statements assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

7.2.4 Internal control as part of the external audit

According to ISA 400 the internal control system means all the policies and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of accounting records, and the timely preparation of reliable financial information. ISA 400 is currently being updated whereby the new standard is expected to take a broader view of what the auditor needs to understand about control, and its implications for the audit. The internal control system extends beyond those matters which relate directly to the functions of the accounting systems and comprises:

(a) The control environment (see section 4.5.)

(b) Control procedures which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- Reporting, reviewing and approving reconciliations,
- Checking the arithmetical accuracy of the records,
- Controlling applications and environment of computer information systems,
- Comparing internal data with external sources of information,
- Comparing and analysing the financial results with budgeted amounts.

In the audit of financial statements, the auditor is mainly concerned with those policies and procedures within the accounting and internal control systems that are relevant to the financial statement assertions. As part of the assessment of control risk the auditor performs an evaluation of the control environment at an entity-wide level. The quality of the factors that form the control environment, such as the tone of the organisation, its control consciousness, integrity of its leadership, organisational structure and assignment of authority and responsibilities have significant impact on the auditor’s ability to rely on controls, including those that are formally established. Thus, a poor control environment will negatively affect the auditor’s assessment of the potential for reduction in control risk provided by established controls. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- Identify the types of potential misstatements that could occur in the financial statements;
- Consider factors that affect the risk of material misstatements; and
- Design appropriate audit procedures.

7.2.5 Fraud

The term “fraud” refers to an intentional act by one or more individuals among management, those others charged with monitoring and supervision, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of intentional misstatements are relevant to the auditor’s consideration of fraud – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users.

The primary responsibility for the prevention of fraud and error rests with both those charged with the monitoring and supervision and the management of a company. Management, with the oversight of those charged with monitoring and supervision, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the company.

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. An audit conducted in accordance with ISAs is designed to provide reasonable assurance that the financial statements as a whole are free from material misstatements, whether caused by fraud or error.

An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgement, the use of testing, the inherent limitation of internal control (see section 4.3.2) and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

For these reasons the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements will be detected. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement from error because fraud may involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures.

7.3 Communication of the audit results to those charged with governance

An active and constructive dialogue between the external auditors, management and especially those bodies which are charged with monitoring and supervision of the audited company, i.e. the audit committee and the (supervisory) board, is important, both to ensure that the external auditors are aware of relevant information in order to be able to draw reasonable conclusions on which to base the audit opinion and to inform management, the audit committee and the (supervisory) board on the results of the audit.

According to ISA 260 on "Communication of audit matters with those charged with governance" the auditor is required to communicate matters, that come to his or her attention as a result of the performance of the audit of financial statements and are important and relevant for overseeing the financial reporting and disclosure process, at a timely basis to the appropriate bodies within the company which are charged with monitoring and supervision. Such matters include, for example:

- The general approach and overall scope of the audit, including any expected limitation thereon, or any additional requirements;
- The selection of, or changes in, significant accounting policies;
- The potential effect on the financial statements of any significant risks and exposures;
- Material audit adjustments, whether or not recorded by the company;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- Disagreements with management about accounting and auditing matters;
- Expected modifications of the auditor's report; or
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.

The Sarbanes-Oxley Act of 2002 requires the auditor to report directly to the audit committee about the following issues:

- All critical accounting policies and practices to be used;
- All alternative treatment of financial information within generally accepted accounting principles that have been discussed with management and the treatment preferred by the auditor; and
- Other material written communications between the auditor and the management, such as any management letter or schedule of unadjusted differences.

These enhanced reporting requirement of Section 204 of the Sarbanes-Oxley Act are further specified by the SEC implementation provisions, for example:

- Methods used to account for significant unusual transactions;
- Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- Process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates;

- Auditor’s judgments about the quality of the company’s accounting principles;
- Material audit adjustments proposed as well as immaterial adjustments not recorded by management.

FEE recommends that the external auditors should communicate to the audit committee the company’s significant accounting policies and practices including, where appropriate, alternatives and their assessment of the principal accounting judgements exercised.

FEE encourages IAASB to enhance the ISA 260 in relation to audit matters of governance interest to be communicated to cover appropriate alternative accounting policies and accounting estimates.

By communicating such information to the (supervisory) board and the audit committee the external auditor supports those bodies in fulfilling their own tasks both with regard to external reporting and – taking for example the information on internal (financial) control and management fraud – with regard to their wider monitoring tasks. For example, the information obtained from the external auditor on accounting matters would enable the audit committee to enter into the discussions between the external auditor and management in order to find appropriate solutions on the accounting issues under discussion taking into account the opinion of management and the audit committee and to ensure that the external auditor gets all the information needed to conduct the audit in a proper and effective way.

However, not all matters of interest to the NEDs and the audit committee will necessarily come to light in the course of an audit of the company’s financial statements. Consequently, it is very important that the limitations of an audit are made clear to the NEDs and the audit committee, so that they are able to make an informed decision as to whether further investigation is needed.

ISAs do not require a certain format for the communication. The communication may be oral or in writing. In some countries a tradition has been built for detailed written communication, through either a management letter or a “long form” (extended and detailed) audit report. Particularly, the long form (extended) audit report is recognized in countries having this tradition as a cornerstone in the communication between the auditor and the (supervisory) board and the audit committee. The long form audit report provides the board with a thorough outline of the audit strategy, the audit procedures performed and the conclusions drawn by the audit on this basis. It is only distributed to the board and the audit committee and is not intended for audiences outside those charged with governance of the company. Therefore, it presents itself as a tool for the (supervisory) board and the audit committee to understand and reflect on the audit work performed and its effect for the board’s considerations and responsibilities. However, the tradition of detailed written reporting also include caveats. The use of written reports can become a barrier for communication in the sense that the (supervisory) board feels well informed and no particular need to explore the views of the auditor further. Also, the auditor in practice seems to be running a risk of being very restricted in his discussions by the fact that he has already communicated all material matters in writing, and this communication must in and by itself be exhaustive for the purpose of the (supervisory) board and its responsibilities.

FEE recommend that (supervisory) boards explore the use of extended (usually referred to as “long form”) reports to boards by external auditors in combination with oral presentations and discussions allowing for more informal and in-depth exchange of views between the auditor and the audit committee or board. This would provide improved clarity and focus for the benefit of the (supervisory) board and audit committee in fulfilling their responsibilities.

FEE recommends that the external auditors provide members of the audit committee and other members of the (supervisory) board and with a basic understanding of the audit process, the specific audit strategy adopted for the company as well as the limitations of the audit process compared to the relevant risks to the company.

In order to ensure an active and constructive dialogue between those charged with monitoring and supervision and the external auditors a process should be established by which regular meetings are held during the year, both in the presence of management and independently of management (see chapter 8 audit committees).

In the meeting of the audit committee and of the supervisory board held after the completion of the audit the external auditor could submit an oral report (in addition to the written report) on the essential audit findings and governance matters, that came to the auditor's attention as a result of the performance of the audit of financial statements. The oral communication which is based on the written report enhances the effectiveness of communication with the (supervisory) board and the audit committee by focusing on the essential findings of the audit, explaining in depth some of the findings and assuring that the material information is conveyed and understood (see chapter 8 audit committees).

7.4 Assurance on Internal Control

Section 4.3 discussed a number of the difficulties in reporting on the effectiveness of internal control. Sarbanes-Oxley 404 require US SEC registrants to report on the effectiveness of internal controls over (external) financial reporting. Also, their auditors should attest to the reporting on effectiveness. As discussed in chapter 4, internal control can be viewed in its narrow financial perspective or in its wider sense. Where the UK, through Turnbull, adopted a wide perspective on internal control and reporting thereon the US has selected a narrow financial approach. Where the UK only require boards to assess, but not report on, effectiveness the US now requires an assessment, as at a specific date, of the effectiveness of internal controls over financial reporting and the external auditor is required to attest to management's assessment.

Definition of internal Control	Formal opinion on effectiveness, publicly reported by the board: No	Yes
Wide	CoCo, Turnbull, COSO	
Narrow		Sarbanes-Oxley

ISA 100 states that an assurance engagement requires three parties: a responsible party, an intended user and an auditor. It requires a subject matter and a set of suitable criteria against which the subject matter must be measured. For example, in the preparation of financial statements the criteria may be International Financial Reporting Standards. In an audit of the financial statements the auditor provides assurance as to whether the financial statements give a true and fair view of a company's financial position, results of operations and cash flows using the accounting framework to evaluate the preparation of and presentation of the subject matter.

ISA 100 outlines the characteristics that constitutes a set of suitable criteria in order to be able to provide high level of assurance. These are:

1. Relevance: relevant criteria contribute to conclusions that meet the objectives of the engagement, and have value in terms of improving the quality of the subject matter, or its content, so as to assist decision making by intended users;
2. Reliability: reliable criteria result in reasonable consistent evaluation or measurement and, where relevant, presentation of the subject matter and conclusions when used in similar circumstances by similarly qualified professional accountants;
3. Neutrality: neutral criteria are free from bias. Criteria are not neutral if they cause the practitioner's conclusion to mislead report users;
4. Understandability: understandable criteria are clear and comprehensive and are not subject to significantly different interpretation; and
5. Completeness: complete criteria exist when all the criteria that could affect the conclusions are identified or developed, and used.

In order for the auditor to report on the effectiveness of internal control, as a subject matter, with a high level of assurance a set of suitable criteria must exist. No existing framework meets all these above criteria fully. In particular, the presentation and assessment of the control environment of a company presents significant challenges by its inherent subjective nature and is open to significantly different interpretation. If boards make a statement on their process for reviewing internal control, auditors could report upon the statement.

The SEC rule on Section 404 of the Sarbanes-Oxley Act equates effectiveness with 'free from material misstatement'. This criterion may be appropriate for the SEC in its objective of preventing material misstatement in financial reporting but may not be appropriate when assessing the wider aspects of internal control.

7.5 Role of the external auditor with regard to disclosures on corporate governance

The market can only act as an enforcer of proper and effective corporate governance structures within the companies if it receives appropriate and reliable information on corporate governance performance and adherence to the code from companies. Hence, if the proposal, in chapter 6, for preparing and issuing a corporate governance statement as part of the annual report is introduced, it is necessary to ensure these statements are reliable.

In this context it is worth discussing whether and to what extent the external auditor can play a role in enforcing the disclosure requirement on corporate governance.

Under the existing auditing standards auditors have different responsibilities with respect to the various components of the annual report. Not all parts of the annual report are subject to full external audit. For example, in most Member States only the financial statements are required to be audited, whereas other parts of the annual report such as the board's report to the shareholders have to be checked for consistency with the audited financial statements. Other Member States, however, have already introduced audit requirements for the directors' report. For example, in Denmark the directors' report is subject to audit requirement. The preparation of the directors' report is the responsibility of management as well as the supervisory board and would often include governance disclosure. Under the Belgian Company Code, the statutory auditor must give an opinion, in its auditors' report, on the content of the annual report by the board of directors to the general meeting of shareholders.

The Directive modernising the Accounting Directives requires amending Art. 51.1 of the Fourth Directive: "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."

FEE encourages debate on whether capital market participants see benefits in independent assurance on the corporate governance statement. However, the external auditor can express an opinion on whether only certain aspects of the corporate governance statement comply with certain defined reporting requirements and/or guidance – which have yet to be developed. Respecting the limitations of the auditor's role resulting from the audit approach and the role of the auditor within corporate governance, FEE recommends extending the scope of the external audit to require the auditor to examine whether certain appropriate aspects of the corporate governance statement comply with the respective reporting standards. FEE encourages all parties involved in the EU corporate governance discussion to work on a EU-wide common "comply or explain" approach on this issue.

Also, the auditor would also not be able to express an opinion on whether and to what extent the reporting company has adequate corporate governance or whether the reporting company complies with all aspects of a corporate governance code, as stated in its compliance statement. An audit of the appropriateness of the compliance statement would require an audit of the propriety of management and the adequacy of management organization, instruments and transactions. Assessing the adequacy of management is the primary task of those charged with governance (NEDs, audit committee, etc.) and extending the external audit in this way would interfere with their separate responsibility for reporting on financial information. Neither would this be desirable as it would create another expectation gap with regard to the role of the external auditor.

7.6 Key issues for ensuring high quality audits of financial statements

7.6.1 Appropriate regulation of the audit profession

(a) Professional standards on auditors' independence and objectivity

Commitment to professional ethics is crucial to the accountancy profession and to the credibility of the external auditor. In the public view, the auditor's independence is a prerequisite for the reliability and credibility of the audit of financial statements.

Therefore, FEE strongly supports the Commission's Recommendation on "Statutory auditors' independence in the EU: A set of fundamental principles", which emphasizes the responsibility of the audit profession to uphold auditor independence. Adopting a principle-based approach in line with the IFAC Code of Ethics the recommendation sets out fundamental principles which must always be observed by the auditor and recommends important safeguards to auditors' independence and objectivity which would contribute to the continuous improvement of the system in the EU Member States. FEE supports the Commission's proposal in the Commission's Communication on Statutory Audit to incorporate the basic principles of the Recommendation in the Eighth Directive so as to provide a stronger, legal underpinning for auditor independence in the EU.

Within Europe it is essential that Member States act within the common framework provided by the European Commission and do not diverge unnecessarily from European and global norms. Specifically individual Member States should avoid, even inadvertently, introducing regulations with extraterritorial effect.

(b) *High quality auditing standards*

Within each EU Member State, local regulations govern, in more or less detail, practices followed in auditing financial statements, even if methods are already aligned with the International Standards on Auditing (ISA) developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). This objective has already been achieved to a very large extent for publicly listed companies, as all large accounting firms since several years have implemented audit processes globally in compliance with ISAs.

FEE supports the mandatory application of International Standards on Auditing (ISAs) to all audits in Europe. FEE proposed in November 2001, that by 2005, EU national auditing standard setters should require auditors to perform audit procedures that comply with ISAs and to report on financial statements in accordance with the same international standards. FEE has also recommended a new format of the audit report which would allow European auditors to demonstrate clear compliance with ISAs whilst providing additional information as required by national laws and standards.

(c) *Effective and transparent quality assurance systems and disciplinary regimes*

The establishment of high quality ethical and auditing standards needs to be accompanied with appropriate and effective systems of quality assurance and disciplinary regimes in order to ensure that the established standards are properly applied in performing external audits. While quality assurance systems mainly have a preventive effect by substantially reducing the risk of audit failures, an effective disciplinary regime is necessary to investigate public suspicions of violations of professional requirements and apply clear sanctions where those suspicions are confirmed.

The European Commission's Recommendation on "Quality Assurance for the Statutory Audit in the European Union: minimum requirements", of 15 November 2000 is an important step towards assuring high quality audits. There are essentially two different methodologies of quality assurance applied within the European Union: monitoring and peer review. Monitoring refers to a situation where staff employed by the professional body or regulator manages the quality assurance system and carries out the quality assurance reviews. Peer review refers to a situation where (active) members carry out review visits. According to this recommendation both peer review and monitoring are acceptable methodologies for quality assurance. Monitoring and peer review are considered as methodologies of equal stature. However, in either case, care should be taken to ensure both the quality of the reviewers and their objectivity.

The European Commission has announced a review of the implementation of the minimum requirements of the Recommendation within the near future. Taking the importance of appropriate and effective quality assurance systems for restoring public confidence in the audit profession FEE would be pleased to co-operate in this work.

FEE also supports the European Commission's proposal to incorporate some key elements of this Recommendation into European legislation. This will help to guarantee that oversight of the auditing profession and the quality assurance system is seen to be carried out in accordance with common European benchmarks, thus supporting the single market and also dialogue with regulators in other jurisdictions.

(d) Public oversight arrangements

The objective of regulation of the profession is to ensure that the profession is achieving the goal of maintaining technical, educational and ethics standards at the level the public has a right to expect. In order to secure the credibility of the audit profession and of the auditor's work in public and to avoid accusation of self-interest a sufficient level of public guarantee needs to be added to the regulation of the profession through appropriate oversight arrangements.

The European Commission has announced in the Communication work on the establishment and implementation of common minimum principles for proper public oversight of the auditing profession at national and on co-ordination of this at European level. The objective is to restore confidence in financial information and to provide a further contribution to the establishment of the single European capital market. There is a need for common rules and practices aiming at a level playing field in Europe with equivalent guarantees of audit quality despite the differences in oversight systems.

The reactions to US financial scandals and to the Sarbanes-Oxley Act in the European Parliament, in the Member States and in the European media emphasize the urgency of initiatives aimed at demonstrating that the auditing profession in Europe is submitted to a robust system of oversight. Therefore, FEE strongly welcomes the initiative of the European Commission and is ready to work with the Commission on these issues. With the aim of contributing actively to the European debate, FEE issued a discussion paper on "European co-ordination of public oversight" setting out concrete proposal for defining common principles on public oversight and clarifying how a strong national oversight should be accompanied by a form of co-ordination at EU level.

7.6.2 Appropriate corporate governance structures within the audited company

The corporate governance structure within a company should also provide a means of ensuring the external auditor's independence and objectivity and, thereby, to contribute to an enhanced quality of the external audit in the interest of shareholders and other stakeholders of the company. The audit committee has an important role to play (see section 3.4 and chapter 8.)

Recommendations

7.1 FEE recommends that (supervisory) boards explore the use of extended (usually referred to as "long form") reports to boards by external auditors in combination with oral presentations and discussions allowing for more informal and in-depth exchange of views between the auditor and the audit committee or board. This would provide improved clarity and focus for the benefit of the (supervisory) board and audit committee in fulfilling their responsibilities.

7.2 FEE recommends that the external auditors should communicate to the audit committee the company's significant accounting policies and practices including, where appropriate, alternatives and their assessment of the principal accounting judgements exercised.

7.3 FEE recommends that the external auditors provide members of the audit committee and other members of the (supervisory) board and with a basic understanding of the audit process, the specific audit strategy adopted for the company as well as the limitations of the audit process compared to the relevant risks to the company.

7.4 In order to ensure an active and constructive dialogue between those charged with monitoring and supervision and the external auditors a process should be established by which regular meetings are held during the year, both in the presence of management and independently of management.

7.5 FEE encourages debate on whether capital market participants see benefits in independent assurance on the corporate governance statement. However, the external auditor can express an opinion on whether only certain aspects of the corporate governance statement comply with certain defined reporting requirements and/or guidance – which have yet to be developed. Respecting the limitations of the auditor's role resulting from the audit approach and the role of the auditor within corporate governance, FEE recommends extending the scope of the external audit to require the auditor to examine whether certain appropriate aspects of the corporate governance statement comply with the respective reporting standards. FEE encourages all parties involved in the EU corporate governance discussion to work on a EU-wide common "comply or explain" approach on this issue.

8 RESPONSIBILITIES OF THE AUDIT COMMITTEE

8.1 General overview

As stated in 3.4 the audit committee is a preparatory committee of the (supervisory) board. Responsibilities of the audit committee will include the independent monitoring, assessing and questioning of the work of management in relation to financial statements and other relevant documents to be published externally by the board.

The Commission will, as indicated both in the Communication on Statutory Audit and in the Communication on Company Law and Corporate Governance, address the audit committee (governance body). In the modernisation of the Eighth Directive principles on the appointment, dismissal and remuneration of statutory auditors will be included whereas other aspects of the audit committees, including supervision of the audit function will be addressed as part of the corporate governance initiatives.

The audit committee undertakes certain tasks on behalf of the board which retains overall responsibility for financial reporting and other related matters. The audit committee's role and responsibilities, included in its terms of reference, should be agreed with the (supervisory) board. Each company is unique and therefore the committee's terms of reference need to suit the individual circumstances of the company, subject to a fundamental core of responsibilities that should apply to audit committees for all listed companies.

FEE suggests that the audit committee's "core responsibilities" should include:

(a) Reviewing financial reporting arrangements: including the review of the interim and annual financial statements, the other financial information published by the company, including related party disclosures, and internal control related to financial reporting to ensure overall balance and transparency;
(b) Monitoring the relationship with the external auditor; and
(c) Monitoring the work and resources of the internal audit function.

The audit committee not only reviews the financial statements but also needs to examine the other published financial information that the markets are most interested in, including the operating review/management discussion and analysis (MD&A), preliminary announcements, pro-forma information, GAAP vs non-GAAP headline figures and forecasts in order to ensure overall balance and transparency in the financial information published by the company. The audit committee should also be satisfied with related party disclosures as part of the more transparent disclosure of groups envisaged following the Winter Group recommendations and the Commission's Communication on Company Law and Corporate Governance.

In addition to this core, audit committees may have additional responsibilities if agreed with the (supervisory) board. These responsibilities will vary from company to company depending on:

(a) Its terms of reference, and
(b) Other factors, which may include the work undertaken by the board and that performed by its other permanent committees (e.g. a risk committee).

In addition to its core functions, FEE recommends that the responsibilities of the audit committee should include reviewing:

- Wider aspects of internal control linked to the significant business risks faced by the company when not addressed by a separate specialised risk committee;
- The company's policy and practice to aid the prevention and detection of fraud;
- The company's policy and practice of corporate conduct and business ethics; and
- Its policies for ensuring that the company complies with relevant regulatory and legal requirements.

In some companies the major business risk may require specific knowledge and experience. In such cases the audit committee may not be equipped to look at these areas and special risk committees could be created, with specialised tasks. Examples would include safety for a railway company and credit risk, currency risk and political risk for a bank.

Whether the audit committee can deal with the above issues on behalf of the (supervisory) board without any further involvement of the entire (supervisory) board or whether the audit committee can act only as a preparatory committee with ultimate responsibility resting with the (supervisory) board depends on legislation in particular countries. For example, in Germany the Stock Corporation Act provides a list of tasks which need to be dealt with by the entire supervisory board, so that the audit committee can act only on a preparatory basis. The examination and approval of the financial statements are part of this list. In France, the Bouton report emphasises the role and responsibilities carried out by the audit committee.

The audit committee's main source of information will be management and but it will also draw considerably on advice from the internal and external auditors. From time to time the audit committee may also seek information from other parties inside and outside the organisation.

Where the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, the committee should make recommendations to the (supervisory) board on the action that it thinks is needed to address the issue or to make improvements and monitor action taken.

8.2 The "core responsibilities" for an audit committee

8.2.1 Financial reporting and related systems of internal control

Although the (supervisory) board has ultimate responsibility for the financial information reported externally by the company, the audit committee's work and discussions primarily focus on reviewing the quality of the financial reporting process and the integrity of, and disclosures in, the company's externally reported financial information. In this context, "financial information" includes annual financial statements, interim reports, prospectuses and other published financial information.

FEE suggests that the audit committee's work should include reviewing:

- The quality and reliability of the company's accounting and financial reporting processes and of those aspects of internal control relevant to accounting and financial reporting;
- The selection and consistent application of appropriate accounting policies, especially the suitability of the critical accounting policies (particularly those relating to revenue recognition);
- The effects and disclosure of any changes in accounting policies;
- The appropriateness of accounting estimates and judgements used by management in preparing the financial statements;

- The extent to which the financial statements are affected by any unusual transactions in the year and how they are disclosed;
- The appropriateness of related party disclosures;
- The overall balance, completeness and clarity of the disclosures in the financial statements so that present a true and fair view; and
- Compliance with accounting standards and with relevant statutory and other requirements for financial reporting.

8.2.2 Monitoring the relationship with the external auditor

A key concern for the audit committee is to ensure that there is a quality audit and that there are no matters that would compromise the independence of the external auditors or affect the robust performance of their duties. The key role of the audit committee with regard to the relationship between the management and the external auditor has also been recognised by the Winter Group: "The audit committee, …, has a key role to play in the relationship between the executive managers and the external auditor." [23] The Communication on Statutory Audit also states: "In particular, audit committees can play an important role in the governance of a company by assisting the statutory auditors to stay at arm's length from management. Audit committees help to ensure high quality financial reporting and statutory audit as well as well functioning, effective internal control including internal audit practices."

FEE suggests that the audit committee's work in relation to external audit should include:

- Playing a key role in the proposed selection and appointment of external auditors and in agreeing and approving the terms and conditions of the audit;
- Monitoring the relationship of the external auditors with the company and its management during the course of the audit to safeguard the auditors' independence.

As already stated in the EU Recommendation on auditor independence, the appointment of the external auditor by persons others than the audited company's management is one of the main safeguard to reduce threats to auditors' independence. FEE supports the proposals of the Winter Group that, as it is already the situation in most EU Member States, the shareholders meeting should be responsible for the election of the external auditor based on recommendations from the (supervisory) board. Although the (supervisory) board makes its recommendation to the shareholders, it should receive a recommendation from the audit committee as to the committee's evaluation of the independence of the recommended external auditor. The FEE paper "A Conceptual Approach to Independence in the Financial Reporting Chain" of 2003 explains how the threat's and safeguards approach can be used by members of the audit committee to assess the independence of the statutory auditor as well as their own independence.

In order to facilitate such a discussion the audit committee should be required to obtain a written statement from the proposed auditor stating whether, and where applicable, which professional, financial and other relationships exist between the external auditor and the company, its management or its affiliates, that according to the auditor's assessment could reasonably be thought to involve risks to his independence and objectivity. This statement, which is also required in the EU recommendation on auditor independence, should also include information on the extent to which non-audit services were performed for the company in the previous year

[23] See p. 70 of the Winter Group Report.

and which are charged or contracted for the current year and on existing proposals or bids for future services contracts.

The audit committee has to evaluate whether or to what extent the disclosed relationships and the non-audit services provided by the auditor compromise the independence and objectivity of the external auditor and whether the level of independence risk that arises from specific relationships is acceptable. Based upon the results of its evaluation, the audit committee should make its recommendations to the (supervisory) board.

The audit committee should also take responsibility for agreeing and approving the terms and conditions of the audit with the elected auditor. The audit committee should have in mind that cost considerations could jeopardize audit quality.

FEE acknowledges that different approaches to independence rules may exist but the EU Commission should carefully consider the risk that these proposals may have a negative influence on the quality of audit services. The provision of non-audit services to an audit client can benefit both the client as well as the financial statements' users as such services can increase the external auditor's understanding of the client's business and may result in a better audit. In addition, under certain circumstances additional services may be a direct consequence of the audit, for instance a recommendation relating to the correction of errors detected during the course of an audit. A external auditor should therefore be allowed to provide services beyond the performance of the audit, provided that the provision of such services does not impair his objectivity by, for example, placing him in a position where he plays a managerial role or where the external auditor might review work either directly prepared by him or in the completion of which he was significantly involved. There are no doubts that self-review should be prohibited. A general prohibition for the external auditor to provide other non-audit services, however, would not be appropriate.

The audit committee should establish – or, depending on the governance structure, at least formulate and recommend - its policy on purchasing non-audit services in line with any applicable legislation, bearing in mind guidance and best practices; it should ensure that, whilst allowing sufficient flexibility to take account of new situations, the overall policy is adhered to and keep under review the external auditors' role and independence. Elements of such a purchasing policy may include:

- Approval of a range of audit related and other services such as due diligence and taxation;
- Delegation to management of an authority to purchase such services up to an agreed parameter;
- Provision for specific approval for large or sensitive assignments; specifically, however, FEE believes that it is not appropriate for the audit committee to approve each individual contract for non-audit services; and
- Provision for regular reporting to the audit committee by management.

The audit committee's report that is included in the board's annual report to shareholders should set out its policy on non-audit services and explain its assessment that there are sufficient safeguards to ensure independence in relation to the provision of these non-audit services.

Depending on the governance structure in place such a policy would be defined by management under supervision of the audit committee, or by the (supervisory) board or audit committee itself. Where the audit committee is not established by law and cannot directly establish the policy, it should formulate and recommend the purchasing policy, for approval by the board as a whole.

It should be noted that the Commission's Recommendation on "Statutory Auditors' Independence in the EU: A set of fundamental principles" requires disclosure of total fee income broken down by four categories: statutory audit services; further assurance services; tax advisory services; and other non-audit services.

The audit committee and the audit firm should ensure that the key audit partners rotate at an appropriate time interval in accordance with the independence requirements for all audits of public interest entities according to the EU Recommendation.

In addition to its work on auditor independence and on agreeing and approving the terms and conditions of the external audit, the audit committee should:

- Consider the audit plan including consideration of the sufficiency of scope and depth of audit coverage;
- Discuss with the auditors their quality control procedures and steps taken to respond to the latest regulatory and other requirements;
- Communicate regularly with the external and internal auditors on (a) the scope, results and performance of their work and (b) their responsiveness to the committee's expectations and concerns; and
- Help to ensure that there is co-ordination if more than one external audit firm is involved, as well as (where relevant) between the internal and external auditors.

8.2.3 Monitoring the work and resources of the internal audit function

See section 5.2.

8.3 Wider aspects of internal control linked to the significant business risks

Many audit committees will also be required to consider the wider aspects of internal control. As stated in chapter 4 of this paper, internal control can be viewed either as those mainly related to financial reporting, or as the wider aspects of internal control linked to the significant business risks faced by an organisation.

The audit committee's role, as decided by the (supervisory) board, may be to review:

(a) The policies and overall process for identifying and assessing business including environmental and reputation risks and managing their impact on the company;
(b) Regular assurance reports from management, internal audit, external audit and others;
(c) The timeliness and reports on the corrective action taken by management; and
(d) Whether the principles of risk management and internal control are being embedded within the company.

The audit committee should also consider any necessary disclosure implications of the process that has been applied by the (management) board to deal with material internal control aspects of any significant problems disclosed in the annual report and financial statements.

Recommendations

8.1 The audit committee undertakes certain tasks on behalf of the board which retains overall responsibility for financial reporting and other related matters. The audit committee's role and responsibilities, included in its terms of reference, should be agreed with the (supervisory) board. Each company is unique and therefore the committee's terms of reference need to suit the individual circumstances of the company, subject to a fundamental core of responsibilities that should apply to audit committees for all listed companies.

8.2 FEE suggests that the audit committee's "core responsibilities" should include:

- Reviewing financial reporting arrangements: including the review of the interim and annual financial statements, the other financial information published by the company, including related party disclosures, and internal control related to financial reporting to ensure overall balance and transparency;
- Monitoring the relationship with the external auditor; and
- Monitoring the work and resources of the internal audit function.

In addition to its core functions, FEE recommends that the responsibilities of the audit committee should include reviewing:

- Wider aspects of internal control linked to the significant business risks faced by the company when not addressed by a separate specialised risk committee;
- The company's policy and practice to aid the prevention and detection of fraud;
- The company's policy and practice of corporate conduct and business ethics; and
- Its policies for ensuring that the company complies with relevant regulatory and legal requirements.

8.3 Where the audit committee's monitoring and review activities reveal cause for concern or scope for improvement, the committee should make recommendations to the (supervisory) board on the action that it thinks is needed to address the issue or to make improvements and monitor action taken.

8.4 FEE suggests that the audit committee's work in relation to external audit should include:

- Playing a key role in the proposed selection and appointment of external auditors and in agreeing and approving the terms and conditions of the audit;
- Monitoring the relationship of the external auditors with the company and its management during the course of the audit to safeguard the auditors' independence.

8.5 The audit committee should establish – or, depending on the governance structure, at least formulate and recommend - its policy on purchasing non-audit services in line with any applicable legislation, bearing in mind guidance and best practices; it should ensure that, allowing sufficient flexibility to take account of new situations, the overall policy is adhered to and keep under review the external auditors' role and independence. Elements of such a purchasing policy may include:

- Approval of a range of audit related and other services such as due diligence and taxation;
- Delegation to management of an authority to purchase such services up to an agreed parameter;
- Provision for specific approval for large or sensitive assignments; specifically, however, FEE believes that it is not appropriate for the audit committee to approve each individual contract for non-audit services; and
- Provision for regular reporting to the audit committee by management.

The audit committee's report that is included in the board's annual report to shareholders should set out its policy on non-audit services and explain its assessment that there are sufficient safeguards to ensure independence in relation to the provision of these non-audit services.

APPENDIX – ASSESSING THE INDEPENDENCE OF DIRECTORS

The Winter Group Report provides a list of relationships which would cause a NED to be considered not to be independent:

- "Those who are employed by the company, or have been employed in a period of five years prior to the appointment as non-executive or supervisory director;
- Those who receive any fee for consulting or advising or otherwise, from the company or its executive managers;
- Those who receive remuneration from the company which is dependent on the performance of the company (e.g. share options or performance related bonuses, etc.);
- Those who, in their capacity as non-executive or supervisory directors of the company, monitor an executive director who is non-executive or supervisory director in another company in which they are an executive director, and other forms of interlocking directorships;
- Those who are controlling shareholders, acting alone or in concert, or their representatives. Controlling shareholder for the purposes of this rule could be defined, as a minimum, as a shareholder who, alone or in concert, holds 30% or more of the share capital of the company."[24]

In the US, the Sarbanes-Oxley Act requires each member of an audit committee to be independent. In the Act independence broadly means someone who does not receive any fee other than in his/her capacity as a director or member of a board committee.

The New York Stock Exchange in its corporate governance rules passed in August 2002 significantly tightened this definition. NYSE said no director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company). Companies must disclose these determinations.

In addition:

(i) No director who is a former employee of the listed company can be "independent" until five years after the employment has ended;
(ii) No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship;
(iii) No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director;
(iv) Directors with immediate family members in the foregoing categories are likewise subject to the five-year "cooling-off" provisions for purposes of determining "independence".

The NYSE says a majority of directors should be independent.

[24] See p. 62 of the Winter Group Report.

In the UK, the Higgs review has also said at least half the directors should be independent NEDs. Higgs detailed what would prevent a director from being independent as such relationships or circumstances would include where the director:

- is a former employee of the company or group until five years after employment (or any other material connection) has ended;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than ten years.

The Belgian Company Code contains a specific procedure for operations or decisions between a Belgian listed company and some of its affiliated companies. *In this context*, the Belgian corporate governance law of 2 August 2002 modifying the Company Code states that a committee of three independent directors must appoint one or more independent experts and must report to the board of directors on the financial consequences of the operation or decision. The statutory auditor must also provide a specific report. The workers' council (*conseil d'entreprises – ondernemingsraad*) must be informed of the suggested appointment of independent directors, prior to the approval by the general meeting of shareholders.

For the purpose of this procedure, the Belgian law defines the independent directors, according to criteria's such as:

- A cooling off period of two years (in relation with other employment relationships or functions in the company or an affiliated company, such as director or member of the executive committee); this prohibition applies to some close family members;
- Financial interests as shareholder of the company (with a maximum of 10%) held by the director and other related parties;
- Any other relationships with the company that may impair its independence.

In France, according to the Bouton report, the definition of independent director would be as follows: A director is independent when he has no relationship of any kind whatsoever with the corporation, the group or their management that is such as to influence his judgement. The report gives six criteria to assess this independence and recommends that the proportion of independent directors should be increased to half of the members of the board for companies that have a dispersed ownership structure and do not have any controlling shareholders. The French law, as well as the project currently discussed by the Parliament, do not address this matter.