



Corporate Board Elections and Internal Controls



27th September 2005
Federal Reserve Bank of New York

A free all-day conference co-sponsored by the American Law Institute and the European Corporate Governance Institute

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Briefing: Internal Control in Europe by David Devlin, President, Fédération des Experts Comptables Européens (FEE)

I have an even more demanding job than Professor Coffee. I have to describe the position not just in the United States and in Europe in total but in what amounts to 29 countries and all in ten minutes. Even if it doesn't keep you on your toes for the next ten minutes, it will keep me very lively and active, I hope. I just wanted to, therefore, run through about ten slides and say a word or two about some of the issues I point out.

Dr. Schaub has explained very well the sort of initiatives in this area, which are under consideration by the Commission and are before the Council and Parliament and they are very important in my mind because, just as with the United States, we have lessons to learn in Europe about preventing fraudulent financial reporting.

The second thing is that in the survey that FEE, that is the Fédération des Experts Comptables Européens, did on this subject, we saw 404 as a very big deal indeed about 18 months ago and we noticed that Europe did not have anything very equivalent. So, we decided that we should do a survey and what really it does show is that member states at the moment have a very wide variety of different regimes. Some of them are very well known, like the UK. France, for example, has legislated quite recently for something that is rather like Sarbanes-Oxley but has not implemented the auditor review part. When you look at it, as I say, there is a very wide variety of regimes and the second thing that I would say is, unlike the US, it is not all hard wired in legislation, a lot of it is in codes, and there is, of course, a fair bit of overlap between those two. You often get codes amplifying regulation and saying how it should be applied and so on. From this, if you sit in the middle of Europe, you can conclude that there is quite a lot of scope for comparison of these different regimes and where they place emphasis. For example, if you come to my country, Ireland, you will find that the emphasis is on compliance with quite a wide variety of legal obligations of companies and that is due to history and, in fact, we overlegislated and now that legislation is being just rolled back and into perhaps a more balanced position in all likelihood. There is also good scope for convergence. You could conclude if you see variety, you see scope for convergence.

So, what did our survey look at? Well, it looked at these kinds of questions on the slide. If you just take an example, first of all types of risk, what sort of risks should we be trying to manage and look at and Sarbanes-Oxley really does, as we have learnt today, focus just on the financial reporting piece. I remember being at the SEC Round Table on the first fruits of 404 and hearing an eminent accountant, I think, but he was by then speaking as a director of a big company, say that you could have perfect financial reporting controls in a US corporation and an operational disaster on your hands because it does not address that piece of the equation, nor does it address strategic controls or compliance controls, and is that the right model? If you are in Europe you ask yourself, is that correct?

How far should the requirements go? Is it a question of managing risks? Should the Board have to conclude an effectiveness? How much disclosure is appropriate? If you try to legislate for very detailed disclosures, how safe is it to do that? Because, back to the point that Bill made this morning in respect of auditing firms, (or bank supervision) if you say you are obliged to publish everything, then how much dirty linen can you really wash? How frank is it wise to be and what is the right balance around disclosure and should there be audit involvement, where I have a conflict of interest, I would point out.

Now, I am going to go through some little charts here that give you a flavour of what our survey at the time found. Bear in mind that all surveys, especially those conducted by accountants, involve some broad-brush judgements and some rough approximations and summarisations. So, first of all are there requirements in the 29 countries in Europe we looked at? The answer is yes, generally speaking in 18, applicable to companies generally, no in four countries and, largely following the BCCI case, seven countries have controls applying only to financial institutions. So, after this I am just going to deal with 18 as a base number. I would also say another word, just at this point, that enforcement is an issue not often that closely addressed in Europe, as far as we can see and an exception, again, might be Ireland where we have a relatively new Office of Director of Corporate Enforcement. But that institution is relatively new, seems to be effective, but is not generally copied so far.

So, of the 18 countries, in how many is compliance mandatory under law? In six countries we found it was. You did not have any choice, you had to do it. You did not have to do it in 12, although in seven of them, if you did not comply, you did have to explain. So, we are already beginning to get the flavour that this is quite a patchwork quilt where the requirements were found primarily in codes in about ten of them and primarily in law and regulation in eight. What I could say about that, I think, is that it is probably rather understating the importance of codes because in many cases the generalised requirements of a law or a regulation are amplified in codes.

Now, what types of risks do we have to look at? The financial reporting risk, obviously, is centrestage. The compliance risk is also addressed in 13 countries and operational and strategic risks are supposed to be looked at – and the associated controls, I should always say – in about 13 as well. But bear in mind they are not 13 countries all doing the same thing plus one extra doing financial reporting. There is quite a lot of mixing and matching in the countries surveyed and the details of the requirements are rather different and I have summarised them quite heavily. Broadly speaking there is quite a large support for having a broader scope in terms of controls and the risks they address than in Sarbanes-Oxley. That was to my mind vindicated by the interesting consultation with the market which the UK Financial Reporting Council undertook in a recent review of their Turnbull Guidance on internal control reporting where there was widespread support for a rather broader approach than just financial reporting.

Are people required to manage risks? Yes. Are they required to identify and evaluate risks and associated controls? Yes, in every country. But in how many are the Board obliged to conclude on the effectiveness of their controls? Interestingly, only in about a third of those 18 countries and these are private conclusions as to effectiveness in the first place. Even just to conclude on effectiveness privately, only about six. If you go to disclosure of all that, a general description of the process you have for managing risk and running controls is generally supported but publishing, disclosing, an effectiveness conclusion is quite a minority sport. From memory I think it is in the Netherlands, Sweden has some laws that are, I think, by now implemented, or virtually, and Portugal is said to have something of the same. So, we see here, again, evidence of some disparity.

What about auditor involvement? Now, we know that in the US auditors, with their 150[plus]-page PCAOB auditing standard, in minute detail, are being driven to be rigorous towards their clients and getting themselves in trouble at Round Tables and getting condemned out of hand for not using enough judgement. Well, I could have complained about that a bit but I decided that would not be a good idea. At the moment, should we have external involvement in Europe or do we have it? The answer is that we do have some role in a lot of cases. Curiously, two countries, Greece and Romania, say, yes, auditors should have a look but they don't have any specific reporting obligations. Internal reporting to the Board in about three cases and external reporting is possible, though not common, in five. The example I give you is the United Kingdom, which we use for Irish listed companies. We have analogous procedures. You only, as auditor, have an external reporting obligation of any worth if the directors have decided not to comply with their obligations in which case you have got to say they have not done the job they are supposed to do. But there is not anything quite like reporting on 404 assertions by management. Now, there is nothing at all in eight countries.

So, here am I concluding these slides. I am sorry that it is such a quick flit around Europe but it gives you a flavour and, really, the flavour, I guess, to take from it is that there is a lot of variety, there is scope for comparison and convergence and then you say to yourself, well, what do you do with all of that? Well, first of all, you could ask, do we think the high level measures, which Dr. Schaub described to us so clearly, are sufficient? Should we learn from best practice before we act in Europe? What is best practice? Is 404 best practice? What is the experience so far in the United States? We have heard from Professor Coffee. We will hear a bit more, I think, during this panel on the Sarbanes-Oxley Act. I think the US experience has a lot to offer us. And what about EU practice? How are the French getting on with their financial security law? The United Kingdom seems extremely satisfied with their quite well established model of Turnbull and they are just making a few tweaks to that. What should be the role of market forces in convergence and enforcement?

That links back to some of this morning's discussion about the role of shareholders and the rather different position of non-dispersed ownership in parts of Europe. You do not get too much from market forces if you have got block control maybe but certainly I think market forces are bound to have some influence on this rather than relying solely on prescriptive legislation. Just finally a mention, for those of you who might find yourself more or less in a month's time in Brussels, we in FEE are having a seminar to review quite a thick discussion paper on this which is mentioned in your agenda papers where Director General Alexander Schaub and Andrew Bailey, Deputy Chief Accountant of the SEC is also speaking, for example. We are trying to have a structured debate around this in Brussels to see what the direction of events should be. Thank you very much.