MEDEF

AFEP - AGREF

«Promoting Better Corporate Governance In Listed Companies»

Report of working group chaired by Daniel Bouton,

President of Société Générale Bank

Press Conference

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INTRODUCTION

The market economy, based on the free confrontation of supply and demand and, internationally, on freedom of trade, has demonstrated its superiority compared with any other form of economic organization. It must include as a corollary a set of effective regulating mechanisms, as there can be no free-market system without an underpinning of trust in the rule of law.

Such a system cannot tolerate fraud. If fraudulent acts are committed, they must be punished. Most legal systems provide for severe criminal penalties for such acts, and these should be fully applied. French law is particularly well armed in this area, with criminal offences having been created to deal with such abuses as misappropriation of corporate assets, filing of fraudulent financial statements or spreading of false information. However, it would plainly be illusory to imagine that increasing the number or severity of criminal sanctions can offer effective protection against the main risks, which lie in strategic errors or incompetent management.

Such risks cannot be eliminated by any regulatory system, however optimal. It is nevertheless crucial that the rules and practices in place limit such risks and promote ethical behavior on the part of market players. Restoring trust therefore involves making sure that the system includes sufficiently clear and appropriate rules, and ensuring that these rules are fully and effectively implemented. In addition to the moral imperative, this represents a key economic requirement for all developed economies, taken both collectively and individually. Ever more initiatives are being launched in both the United States and Europe, as each country understands that what is at stake is the competitiveness of its businesses and of its financial markets.

Recent events, particularly revelations of questionable accounting practices, have impacted global companies, ruined shareholders and employees, and led to the disappearance of one of the leading audit firms. This has caused a severe breakdown of trust in the very essence of a market economy, namely the quality of corporate governance and the reliability of financial statements. The latter provide the link between the economic reality of each company and its shareholders, both institutional and individual.

In terms of management practices, legislation, some tax or market regulations, accounting standards, as well as professional standards in the fields of accountancy, banking or insurance, French companies find themselves in a very different situation from that of their U.S. counterparts. In many respects, French companies are better protected against the risk of excessive or misguided practices.

Nevertheless, in the face of such a widespread breakdown of trust as we are experiencing, French companies cannot be satisfied with the status quo. It has become clear that a certain number of principles need to be reviewed in the areas of corporate governance, financial disclosure and communication, as well as with respect to the adequacy of accounting standards.

Following the publication of the two Viénot reports in July 1995 and July 1999, France now has a very extensive set of rules of corporate governance, promoting both efficiency and transparency. The progress that has been achieved since 1995 is reflected in the content of the annual reports issued by listed companies.

In April 2002, Bertrand Collomb, Chairman of AFEP-AGREF[1], and Ernest-Antoine Seillière, Chairman of MEDEF[1], wished to assess whether there was a satisfactory match

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[1] Association Française des Entreprises Privées et Association des Grandes Entreprises Françaises (association of French private-sector companies and association of major French corporations).

between the expectations of investors and financial markets, on the one hand, and the body of rules, standards and practices in respect of companies, on the other.

The working group that was set up was charged with examining the following questions:

- Improving the workings of company bodies for management or the supervision of management, in particular the audit committee;

- The adequacy of accounting standards and practices;

- The quality of financial information and communication;

- The effectiveness of internal and external controls (by auditors and regulators);

- Relations between companies and the various categories of shareholders;

- The role and independence of various other market players, such as banks, financial analysts, rating agencies, etc.

The task entrusted to the working group could not replace the ongoing role of existing structures that address these questions, therefore the working group drew upon the work of the MEDEF Ethics Committee, chaired by René Barbier de la Serre, as regards the major question of the role and independence of statutory auditors.

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Due to the vast scale of the task entrusted to it and to the urgency of the situation, the working group did not deal in detail with all of the subjects within its remit. As an example, it has not attempted to make any proposals concerning the institutions in charge of regulating financial markets.

With the *Commission des Opérations de Bourse* (COB) and the *Conseil des Marchés Financiers* (CMF), France has respected, competent and independent market authorities. The announced merger between the two bodies can only be greeted with approval, since it should allow a strengthening of the means of investigation and control which are so vital for a regulatory authority.

These market authorities, as well as the supervisory authorities overseeing banks, brokers and other financial intermediaries, are responsible for ensuring that the rules governing the operation of financial markets constantly achieve an appropriate balance between the interests of issuers and those of investors. The rules relative to the independence of analysts from investment banking services as they have just been defined by the CMF are sound and should help protect the market from some of the excesses that have occurred in the United States. Such rules must be strictly enforced.

Listed companies also expect that professionals in the field of financial information and communication should be governed by a strict ethics code, where they do not already have

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[1] Mouvement des Entreprises de France (French business confederation).

one. Such an ethics code needs to be consistent with the immediate and often very powerful impact of their activities, and should be rigorously enforced.

Similarly, the working group did not review the situation of rating agencies, which play a major role in relations between listed companies and the market. In some cases, whether for countries or for companies, their action has appeared to have a triggering or accelerating effect on a financial crisis, whereas ratings are intended to serve only as indicators of possible problems to come.

The three main rating agencies, which are private organizations, are financed by the issuers that they are in charge of rating. Their role today raises a number of questions for which answers could only meaningfully be reached at the international level, whereas all three are U.S. legal entities. In any event, the requirement of transparency should apply to these companies themselves just as to others. They should therefore, at regular intervals, provide the market with an explanation of their policies and any changes in them, and describe the decision-making processes they apply.

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Recent events raise the fundamental issue of the distribution of responsibilities among the various market players, such as executive management, boards of directors, auditors and regulators. These events did not take place in a de-regulated environment. In the United States in particular, businesses are governed by a great many rules and standards, which are extremely detailed and carry the threat of serious penalties for non-compliance.

What is at issue is not so much the letter of the rules as their spirit, not standards but behavior. Though regulation is of course needed, formal rules and superficial compliance with them cannot be enough. What is needed is for all concerned parties to apply, in good faith, a set of "ground rules", the aims of which are understood and accepted by all.

The working group is convinced that the surest way to improve corporate governance is through the evolution of individual and collective behavior following "best practices" based on fundamental principles consistently applied to all economic players: personal responsibility, transparency and integrity.

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FIRST PART

Further Improving Corporate Governance Practices

The working group noted with satisfaction that in the majority of large French companies the recommendations of the Viénot reports were rapidly implemented. There are, however, some major listed companies that still do not satisfy some of the key principles prescribed by those reports. The working group hopes that those recommendations will be implemented in a manner that takes into account the diversity of legal structures that exists among French companies. French law has for many years provided two methods of organizing a corporation (*société anonyme)*, one with a board of directors and the other with a management board and supervisory board.

The law of May 15, 2001 on "new economic regulations" introduced a new choice for companies governed by a board of directors, to separate the functions of chairman of the board and chief executive officer or to keep them joined. French corporations thus have a choice between three possible models of management and control structures, a situation that is unique among comparable countries. This diversity of options should allow the shareholders and management of each listed company to work out the solution that best fits the nature of the company and its circumstances.

One view is that the separation of functions within the board of directors or in the structure of the supervisory board and management board greatly facilitates control over the workings of the company and appraisal of the pre-eminent corporate officer (chief executive officer or chairman of the management board, as the case may be). An alternative view is that the same result can be achieved in a company led by a chairman and CEO thanks to effective specialized committees (audit committee, compensation committee, etc.).

The working group has not resolved this debate, but reaffirms that the key consideration is transparency. This transparency must be present between executive management and the board of directors, as well as between management and the market or shareholders. For shareholders, the general meeting is not only a time when decisions are to be taken, but also when the corporate leadership reports on the company's operations and on the workings of the board of directors and its specialized committees (audit committee, compensation committee, etc.): and it should be an occasion for opening up a genuine constructive dialog with the shareholders.

The recommendations that follow have been written with reference to corporations with a board of directors, which remains the most common form of organization. Corporations with a supervisory board and management board, as well as partnerships limited by shares (*société en commandite par actions*), will need to make adjustments as appropriate to implement them.

I – ROLE AND OPERATION OF THE BOARD OF DIRECTORS

The Companies Act of 1966 provided a very succinct definition of the board of directors: "*Corporations are governed by a board of directors (...). The board of directors has the broadest powers to act in all circumstances in the name of the company (...)*".

The first Viénot Report pointed out that "*regardless of its membership or how it is organized, the board of directors is and must remain a collegial body representing all shareholders collectively. It is required to act at all times in the interests of the company*." The Report also specified the board of directors' mission as follows: "*[The Board] defines the company's strategy, appoints the corporate officers responsible for managing the company and implementing this strategy, oversees management and ensures the quality of information provided to shareholders and to financial markets through the financial statements or at the time of very important operations.*"

This definition can now be found in article L 225-35 of the French Commercial Code: "*The board of directors sets the direction for company operations and oversees the implementation of strategy (...) it may deal with all issues relevant to the satisfactory running of the company and deliberates and decides upon all matters related thereto.*"

This definition confirms both the preeminent role of the board and the collegial nature of its decisions, one of the consequences being that directors are collectively responsible for decisions that have been made.

Although procedural rules and recommendations concerning the operation of the board and its committees are essential corporate governance standards, any procedure will only be as good as the people implementing it. ENRON complied formally with all these rules and was even considered a model of corporate governance!

The Viénot reports rightly emphasized the importance of the role of specialized committees in the satisfactory operation of a board of directors. These committees cannot be separated out from the board, their role is to facilitate its work and help with the effective preparation of decisions. The board's responsibilities thus should not be shifted onto the committees. For this reason in particular, the working group insists on the need for high-quality reports provided by the committees to the board and on the need to include in the annual report a description of the work of the committees.

The number and structure of committees will be matters for each board to decide upon. Thus, the audit committee's responsibilities generally span the review of the financial statements, risk monitoring and the supervision of internal audit, but in some companies there may be a specialized financial statements committee as well as an audit committee that specifically focuses on risk management issues. Similarly, the compensation committee and the nominating committee may be one and the same in some companies. Lastly, other types of committees may be created within the board of directors, such as a strategy committee.

Following on from the Viénot reports, the working group once again emphasizes that for the following issues preparatory work must be undertaken by a specialized committee of the board of directors:

- Review of the financial statements
- Monitoring of the internal audit function
- Selection of statutory auditors
- Policy on remuneration and stock options
- Appointment of directors and corporate officers (*mandataires sociaux*)[(1)].

↳ The Board of Directors and Strategy

In some cases boards do not devote enough time to discussing strategic issues, and may sometimes even be informed only after the fact of investments, acquisitions or disposals that can have a major impact on the company's future. The same lack of prior discussion can also apply to issues of financing, indebtedness or liquidity. Such malfunctions contradict the principle of collegiality which should underlie the board's operation.

The working group considers that the board of directors' internal rules of operation should specify board procedures for dealing with such matters.

> The board of directors' internal rules of operation should specify the following:
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> - *Cases in which prior approval by the board is required, specifying the principles governing such approval, which may vary from one of the company's divisions to another.*
>
> - The principle that any material transaction that is not part of the company's announced strategy should require prior approval by the board of directors.
>
> - The rules under which the board is informed of the company's financial position, cash flow situation and commitments.
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> All these rules should apply not only to external acquisitions or disposals, but also to any major organic growth investments or to internal restructuring operations.

↳ Directors' Access to Information

The second Viénot report emphasized that informing directors in advance and on an ongoing basis is an essential requirement for the satisfactory performance of their duties. This point remains as important today as ever.

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(1) In this report, the term of *mandataires sociaux* (translated as "corporate officers") applies to the chairman of the board, the chief executive officer and the chief operating officer(s) in companies with a board of directors, and to the chairman and members of the management board in the case of companies governed by a management board and supervisory board.

The working group wishes to make four recommendations in this area :

1. Although competence should be one of the key criteria governing the selection of a director, it cannot be assumed that the newly-appointed person has in-depth prior knowledge of the company's organizational structure and operations. The director's knowledge of the company should therefore be rounded out as needed. Each director should be able to obtain, if he or she deems it necessary, additional training concerning the specific features of the company, its lines of business and its markets.

2. The company should on an ongoing basis be supplying its directors with all relevant information, including of a negative nature, concerning the company, notably press clippings and analyst reports.

3. The directors should meet the key executives of the company, including without the corporate officers being present. Of course, in such cases, the latter should be informed of the meetings beforehand.

4. A recent law enshrined the principle that "*each director should receive all information needed to fulfill his or her duties*" and that each director "*can obtain any and all documents that he or she sees fit to request*". The way in which this right of access to relevant documents can be exercised and the confidentiality obligations attached thereto should be further specified in the board of directors' internal rules of operation. Should the need arise, the board of directors as a whole would be responsible for deciding upon the relevance of any specific documents that have been requested.

II – BOARD OF DIRECTORS COMPOSITION

The quality of a board is determined first and foremost by its membership. Directors need to be not only individuals of good character, who have a sound understanding of the workings of the company and have a lively concern for the interests of all shareholders. They should also play a sufficiently active role in contributing to board discussions and shaping strategy to be effectively involved in the collegial decision-making process, the outcome of which they should then support appropriately.

A board should therefore be a subtle mix of competence, experience and independence serving the company and its shareholders. The aspects of competence and experience cannot be over-emphasized as the key qualities of directors. Directors should have a strong command of the strategic issues at play in the markets where the company is present, and this requires a sound knowledge of its businesses.

A designation as independent director does not imply a value judgment. Independent directors are not by their personal qualities supposed to be different from the other directors in a way that would make them more disposed to act in the interests of the shareholders. The designation as “independent” simply goes to the objective situation of the director, who is thus deemed not to have any potential conflicts of interest with the company.

The question of the definition and number of directors qualifying as independent directors is once again a subject of debate in many countries. Definitions of independence vary from country to country, and the notion of "independent" is often mistaken, particularly in the

United States and the United Kingdom, for "non-executive" or "external." The definition given by the Viénot II report is far more demanding:

> *An independent director is to be understood not only as a "non-executive director", i.e., one not performing management duties in the corporation or its group, but also one devoid of particular bonds of interest (significant shareholder, employee, other) with them. For the sake of simplicity, an independent director can be defined as follows: "A director is independent of the corporation's management when he or she has no relationship of any kind whatsoever with the corporation or its group which might risk coloring his or her judgment".*

The working group considers that this definition, which remains essentially sound, should be made more precise on one point, namely that the absence of relationship should apply not only to the company or its group but should be extended to cover relations with the executive management of the company or group.

The definition of independent administrator would therefore be drafted as follows:

"A director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to color his or her judgment".

Although the quality of a board can never be equated with its percentage of independent directors – since what counts above all is that directors be competent, present and actively involved – the working group is convinced of the importance of this criterion. The Viénot II report called for boards to have "at least one third" of their directors be independent, and today we recommend that this proportion should rapidly be increased to <u>half</u> of the members of the board in companies that have a dispersed ownership structure and do not have any controlling shareholders.

With this in mind, the status of independent director, which today is often applied to quite different kinds of situations, should be discussed by the nominating committee and reviewed on a yearly basis by the board prior to publication of the annual report.

Following upon a proposal of the nominating committee, the board of directors should review on a case by case basis the situation of each of its members with regard to these criteria, then make known to the shareholders, in the annual report and at any general meeting of shareholders at which any directors are to be elected, the results of its review, so that the designation of independent directors is not carried out only by the company's executive management but by the board itself. The board of directors may consider that, although a particular director meets all of the above criteria, he or she cannot be held to be independent owing to the specific circumstances of the person or the company, due to its ownership structure or for any other reason, and the converse also applies.

For purposes of clarity, the criteria that the committee and the board should examine in order to determine whether a director can be called independent and help avoid the risk of conflict of interest between the director and executive management, the company or its group, should be as follows:

- The director is not an employee or corporate officer (*mandataire social*) of the company, nor an employee or director of its parent or of one of its consolidated subsidiaries, and has not been one during the previous five years.
- The director is not a corporate officer of a company in which the company holds, either directly or indirectly, a directorship, or in which a directorship is held by an employee of the company designated as such or by a current or former (going back five years) corporate officer of the company.
- The director is none of the following (whether directly or indirectly) a customer, supplier, investment banker or commercial banker – in each case :
  - which is material for the company or its group, or
  - for which the company or its group represents a material proportion of the entity's activity.
- The director does not have any close family ties with a corporate officer (*mandataire social*) of the company.
- The director has not been an auditor of the company over the past five years (article L 225-225 of the French Commercial Code).
- The director has not been a director of the company for more than twelve years[(1)].

As for directors representing significant shareholders of the company or its parent company, the working group proposes that they be considered independent as long as they do not in whole or in part control the company ; beyond a threshold of 10% of the share capital or voting rights, the board acting upon a report from the nominating committee, should examine individually each case in order to determine whether the given director may be considered independent or not, taking into account the composition of the share capital of the company and whether there exists potential for any conflicts of interest.

(1) The loss of the status of independent director based on this criterion should come into effect only at the end of the term within which the director completes 12 years on the board.

<u>III – EVALUATION OF THE BOARD OF DIRECTORS</u>

The Viénot reports emphasized the importance of assessing board performance. It must be said, however, that very few boards of directors have carried out a formal evaluation of their own operation.

Evaluations nevertheless remain essential. Their aim should be to achieve the following three goals:

- assess the way in which the board operates,
- check that the important issues are suitably prepared for and discussed,
- measure the <u>actual contribution</u> of each director to the board's work through his or her <u>competence</u> and <u>involvement in discussions</u>.

The working group believes that annual evaluations are necessary, to be conducted as follows:

- Once a year, the board should dedicate one of the points on its agenda to a debate concerning its operation.

- There should be a formal evaluation at least once every three years. It could be implemented, possibly under the leadership of an independent director, with help from an external consultant.

- The shareholders should be informed each year in the annual report of the evaluations carried out and, if applicable, of any steps taken as a result.

- In some countries, it is established practice that the directors that are external to the company (i.e. are neither corporate officers nor employees) meet periodically without the "in-house" directors. The majority of the working group recommends this practice. The internal rules of operation of the board of directors could provide for such a meeting once a year, at which time the evaluation of the chairman's and chief executive officer's respective performance would be carried out and the participants could reflect on the future of the company's executive management.

IV – THE AUDIT COMMITTEE

The Viénot reports recommended the setting up of audit committees (also known as financial statements committees). The working group reaffirms the importance for listed companies of having an audit committee, whose mission cannot be separated from that of the board of directors which is responsible for approving the parent company and consolidated financial statements. Thus the audit committee must not take the board's place with regard to these responsibilities, but must remain an arm of the board that facilitates the board's work. To ensure that the respective roles remain clear, the working group believes that a certain amount of formality should be maintained in the workings of the committee :

- Rules of operation specifying responsibilities and operating procedures should be drawn up by the audit committee and approved by the board.
- Its reports to the board must ensure that the board remains fully informed of the work of the committee.
- The annual report should include a description of the work of the audit committee for the given reporting period.

The definition of the responsibilities of the audit committee set out in the Viénot reports remains appropriate today. However, it appears that current practice sometimes lags behind the standards which have been set in the past for these committees. The working group re-emphasizes the importance of having audit committees carry out fully their proper mission.

✎ Composition

The Viénot report stated that independent directors should account for at least one-third of the members of the audit committee.

The working group recommends that the proportion of independent directors in the audit committee be raised to two-thirds and that no corporate officer (*mandataire social*) be part of its membership.
Further, if the nominating committee recommends that the chairman of the audit committee be reinstated for another term, this should be subject to specific review by the full board.

The chairman of the committee should be in charge of appointing the person responsible for keeping the minutes of the committee's meetings and preparing its meetings.

✎ Training of the Members

The members of the committee, in addition to their existing financial management and/or accounting expertise, should upon appointment be informed of the company's specific accounting, financial and operating features.

➷ Working Methods

Audit committees should interview the auditors, but also the chief financial officer as well as the heads of the accounting and treasury departments. If the committee so wishes, it should be able to hold such hearings without the company's executive management being present.

The committees should review the scope of consolidation and, if applicable, the reasons why some companies have not been included.

The committees should be able to call upon outside experts if and when necessary.

As regards internal audit and risk control, committees should examine material risks and off-balance-sheet commitments, interview the head of internal audit, express their view of the organization of this department and be informed of its work program. They should be on copy of internal audit reports or of periodic summaries of these reports.

➷ Relations with Statutory Auditors

In addition to regularly interviewing the statutory auditors, including without the executive management being present, the committee should drive the process of selecting the statutory auditors, express an opinion on the amount of fees requested for statutory audit work and submit the results of the selection process to the board of directors.

The committee should be informed of the amount of fees paid by the company and its group to the audit firm and its network, and ensure that the amount and the proportion that the fees represent in the billings of the audit firm and its network do not risk jeopardizing the independence of the auditors.

More generally, the committee should monitor compliance with the rules designed to ensure auditor independence and that are recommended in this report.

➷ Review of the Financial Statements

The audit committee needs to be able to carry out its mission in full, and therefore:

- It must have enough time to conduct its review of the financial statements (at least two days prior to review by the board),
- Alongside the financial statements submitted for review, the audit committee should be provided with a report from the statutory auditors setting out key points, not only of results, but also of the accounting options that were selected, and with a report from the chief financial officer describing the company's risk exposures and material off-balance sheet commitments.

V – COMPENSATION COMMITTEE

The compensation committee plays a very important role in the workings of the board of directors. This committee should not include any corporate officers (*mandataires sociaux*) and should include a majority of independent directors.

The working group again draws attention to the above requirements from the Viénot reports and wishes to make the following additional recommendations:

- Rules of operation laying out its responsibilities and operating procedures should be drawn up by the compensation committee and approved by the board.

- Its reports to the board must ensure that the board remains fully informed of the work of the committee.

- The annual report should include a description of the work of the compensation committee for the given reporting period.

↳ Compensation of Executive Management

Compensation policy for executive management is a major component of sound corporate management. It is healthy that this policy provide for a long-term partnership between the company, the shareholders and the key players in its medium-term strategy. It should seek to avoid some of the excesses that have occurred in the form of disproportionate focus on the short term, causing a divorce between the personal interest of executive managers and the company's interest.

Control over this policy by the compensation committee and the board must be a cornerstone of corporate governance.

French law already includes precise rules concerning transparency of compensation and benefits in kind granted to corporate officers (*mandataires sociaux*). The working group reviewed practices in other countries and the majority of its members felt that it was not advisable to alter the French rules under which the board of directors sets the compensation of the chairman, the chief executive officer and chief operating officers, and the shareholders are informed through the annual report, which must also include a discussion of the principles and processes applied in the setting of these officers' compensation.

The compensation committee has a central role to play in setting the variable portion of corporate officers' remuneration. It must define the rules governing the setting of this variable portion, ensuring that these rules are consistent with the annual performance evaluation of these corporate officers and with the company's medium-term strategy; it must then verify the implementation of these rules on an annual basis.

It should also assess all compensation and benefits in kind received by these officers from other group companies, including, if applicable, pension benefits and any other benefits.

↳ Others Matters for this Committee

Further, the committee should be kept informed of policy governing remuneratio of the main executive managers who are not corporate officers. Naturally, the committee may call upon the participation of the corporate officers in this area.

↳ Stock Options

The working group wishes to point out from the outset that, due to differences among the various tax and legal environments, the term "stock options" covers very different realities and that some of the practices that have caused concern in certain countries are not possible in France.

The commonly-used term of stock options in fact covers two types of options: options to subscribe for new shares, on the one hand, and options to purchase existing shares on the other. Because they give rise to the issue of new shares, stock *subscription* options have a potentially dilutive effect for shareholders. The dilution of capital stock can reach substantial proportions if a large number of subscription options are granted. This was the case in a number of U.S. companies and in start-up ventures in various countries. Conversely, stock *purchase* options have no dilutive effect, since they only entitle the holder to purchase existing shares, although they can generate a gain or loss for the company upon exercise of the option. There is therefore a difference in nature between these two types of options. Major French companies have increasingly tended to grant stock purchase options rather than subscription options, to avoid this dilutive effect.

In contrast with the practices that have arisen in certain countries such as the United States, it should be noted that under French law:

- Only the general meeting of shareholders has the power to authorize the granting of options, to set their maximum number and to determine the main conditions of the granting process;

- The exercise price of the options, which is set based on stock prices at the time of granting, cannot subsequently be revised or altered regardless of stock price trends;

- The holding period of options – the time between the granting of the options and the sale of the shares subscribed for or purchased upon exercise of the options – is directly determined in practice[1] by tax rules: five years minimum from the date of grant for options granted prior to April 2000, four years minimum for options granted after that date. These long holding periods ensure that options granted by French companies do not give their executive management an incentive to focus on a short-term vision. They truly align the management's interests with those of shareholders, in accordance with the very philosophy of stock options;

- Directors who are neither corporate officers nor employees are barred by law from receiving stock options;

- Companies are strictly prohibited from making loans to their executive managers or directors, whether for the purpose of exercising options or for any other purpose. To do so, or to receive such loans, would represent a misappropriation of corporate assets which carries criminal liability;

- Complete and transparent information is provided in the annual report concerning the options granted to corporate officers and the exercise of such options.

To improve further on existing practices, the working group makes the following four recommendations:

It strongly recommends rejection of discounts in the granting of options, in particular for options granted to the company's corporate officers.

It recommends that the general policy governing the granting of options be discussed within the compensation committee and that this committee issue recommendations to the board of directors. This policy, which should be reasonable and suited to the needs of the company, should be presented in the annual report and during a general meeting of shareholders when a resolution on the granting of stock options is on the agenda.

Options should be granted at set intervals to avoid any opportunistic granting of options during an exceptional drop in stock prices. Policy should distinguish between corporate officers, other executive managers and other grantees.

The committee should also make known to the board its proposals concerning the choice between granting subscription or purchase options, specifying the reasons for its choice as well as the consequences that this choice has.

A debate has arisen on the issue of whether stock options should be recognized as an expense. Such a debate is understandable when for tax purposes the cost of options (either subscription or purchase options) is deductible, as it is in the United States for immediately exercisable options, when the gain is considered as a salary. However, a different

(1) Unless the holder is prepared to pay compulsory payroll deductions and income tax at the marginal rate on the capital gain.

economic and legal rationale applies to options which bear more uncertainty due to the length of the holding period, as in France. Purchase options may entail a cost for the company. If, and only if, this proves in the result to be the case, should this cost be recognized as an expense – *i.e.* upon exercise of the options. Subscription options, however, have a dilutive effect for shareholders but do not have any impact on expenses.

↳ Compensation of Directors

The working group notes that the mode of allocation of this compensation, the overall amount of which is set by the general meeting, is determined by the board of directors. The allocation process should take into account the attendance record of each director at board and committee meetings, and therefore compensation should include a variable portion.

Taking into account the changing workloads and responsibilities of directors, each board should consider the appropriateness of the current level of attendance fees, whereby the primary concern should be that the level of compensation allow the recruitment of independent directors of suitable quality.

The rules governing the allocation of attendance fees and the individual amounts paid to directors should be presented in the annual report.

VI – THE NOMINATING COMMITTEE

The board of directors should always include a nominating committee, which may or may not be distinct from the compensation committee, and the chairman of the board should be a member of this committee. This committee plays an essential role in shaping the future of the company, as it is in charge of preparing the future membership of leadership bodies.

The role of this committee has been well defined in the Viénot reports. Its mission is particularly important as regards succession planning for corporate officers and the selection of new directors.

> The nominating committee should organize a procedure designed to select future independent directors, and carry out its own research on potential candidates before they have been approached in any way.

As for the other committees, the annual report should include a description of the work of the nominating committee over the reporting period.

SECOND PART

Strengthening the Independence of Statutory Auditors

The involvement of the Andersen accounting firm in the Enron affair has sparked a number of reviews and discussions in all countries concerning the independence of auditors, i.e. those in charge of carrying out statutory auditing of the financial statements in the interests of shareholders.

The working group does not wish to encroach upon regulatory authorities' handling of this issue, as the *Commission des Opérations de Bourse* has begun work on the subject, nor upon the ongoing review by the accounting profession itself(1).

The working group has been informed of the work of the MEDEF Ethics Committee and approves its findings.

(1) The Le Portz reports issued in 1992 and 1999 set French practices well ahead of U.S. practices. The same applies to the work on professional ethics undertaken by the *Compagnie Nationale des Commissaires aux Comptes*.

The working group wishes to draw attention to the following recommendations:

- Dual auditorship, a specific feature of the French system, greatly reinforces auditor independence. The dual auditing must of course be carried out in practice, meaning that the key issues coming to light during the preparation of the financial statements are truly reviewed twice.

- The term of office, set by law at 6 years, and the fact that it can be renewed, further reinforce independence. However it is also highly desirable that the lead partners in charge of the audit for major firms be rotated regularly, and that the terms of office of the two statutory auditors be staggered.

- The audit committee should be informed of the detail of fees paid by the company and its group to the statutory auditors and to other companies from the same group or network as the auditors.

- When the auditors' term of office expires, the selection or re-appointment of an audit firm should, upon a corresponding board decision, be subject to a tender process overseen by the audit committee, whose aim should be to select the best offer rather than merely the lowest price. The committee should issue an opinion concerning the amount of fees requested in the bids and make its recommendation to the board of directors.

- The statutory auditing of a listed company should be carried out to the exclusion of all other work for that company. The audit firm that has been retained should give up, for itself and the group or network that it belongs to, any consulting work (e.g., legal, tax or information technology consulting) that it has provided directly or indirectly to the company it has been selected by, or to its group.

However, subject to prior approval from the audit committee, ancillary work or work that is directly complementary to the audit of the financial statements can be carried out. As an example, acquisition due diligence audits may be acceptable ancillary work, but no valuation work should be allowed.

The working group believes that this strict approach will help strengthen the independence and responsibility of the statutory auditors.

THIRD PART

Financial Information
Accounting Standards and Practices

Recent events have once again demonstrated the importance of high-quality financial information and the importance of accounting standards and practices.

The following discussion certainly will need to be explored further. The working group would hope to see AFEP and MEDEF play a full part, alongside the accounting profession, in this task which also directly concerns French and European regulatory authorities.

I – FINANCIAL INFORMATION

In terms of the periodicity of financial disclosures, the working group has preferred not to take a position concerning the controversial issue of quarterly accounts. Some feel that quarterly financial statements increase market volatility and promote a short-term focus to the detriment of companies' medium-term strategy. Others feel on the other hand that quarterly financial statements allow investors to adjust their positions more rapidly and also allow management to take corrective measures more rapidly.

It is up to each board of directors to define (within applicable legal constraints) the company's particular communication policy and to present it as transparently as possible to the market. However, each company needs to ensure that it implements a very strict policy in communicating with analysts and with the market. Some practices of "selective disclosure", designed to help analysts with their results forecasts, should be discontinued. The standard method of communication is the press release which provides the same information to all at the same time.

The working group believes that one of the key issues revolves around off-balance-sheet commitments and the company's risk exposure. Off-balance-sheet items can include a large number of commitments given and received, and are often highly varied, ranging from financial commitments to payroll-related matters to sales relationships. The content of off-balance-sheet items also varies according to the accounting standards used. This situation has sometimes caused insufficient attention to be paid to the commitments and risks resulting from liabilities not recognized in the balance sheet for various reasons, or even to a view that off-balance-sheet items constitute a kind of "regulation-free zone" beyond the reach of valuation and disclosure rules.

A company's first obligation in this area is and remains the true and fair application of two core accounting principles: prudence and the primacy of substance over form. Once that is established, the two main objectives should be a careful valuation of off-balance-sheet commitments and of the risks they generate, and appropriate disclosures on these subjects. Each listed company must have in place reliable procedures to identify and value its commitments and risks, and to ensure to its shareholders and investors that it provides them with the relevant information on these matters.

In this context, the working group recommends:

- Indicating in the annual report what in-house procedures have been implemented to identify and control off-balance-sheet commitments and to assess the company's material risks.

- Developing and clarifying disclosures to shareholders and investors concerning material off-balance-sheet commitments and risks:

    - Providing specific information on these subjects in the annual report, presented in a clear and easily understood fashion;

    - Bringing together information on off-balance-sheet commitments in a specific note to the financial statements;

    - Bringing together information on market risks (interest rate, exchange rate, equity, credit, commodities) in a specific note to the financial statements;

    - In the event of a material exposure to interest rate, foreign exchange or commodity price risks, disclosing indicators of sensitivity to these risks, and specifying the methods and assumptions used to calculate these indicators;

    - Publishing ratings of the company issued by ratings agencies and any changes that have taken place in the reporting period.

In addition, accounting standard-setting bodies may have to take steps to design procedures that allow more appropriate presentation of off-balance-sheet items in the financial statements.

II – ACCOUNTING STANDARDS AND PRACTICES

Unlike the previous sections, this part of the report does not put forward recommendations for companies, but records the working group's views in this critically important area and its concern that the current efforts towards harmonization, which companies generally support, be based on principles and procedures that take due account of companies' needs as well as those of investors, intermediaries and regulators.

The quality of accounting standards and practices is central to the satisfactory operation of financial markets and the development of companies. It is therefore essential that we have a single global set of standards that meets four quality criteria:

- Promoting the *stability* of financial markets, economies and corporate financing;
- Facilitating the *understanding* of companies' financial statements, key trends and risks;
- Being *applicable and recognized* by all economic players;
- Producing information that is *trustworthy*, i.e. *reliable and verifiable*.

Standards meeting these criteria would enshrine the principle of the "true and fair view" ("*image fidèle*") which is written into French legislation. Its absence in U.S. accounting standards is probably among the root causes of many of the recent events.

The adoption of IAS/IFRS(1) and the efforts deployed to make them as complete as possible represent major steps forward, which the working group wishes to acknowledge. There was an urgent need to put a halt to the risk of growing discrepancies developing between the accounting standards in force in various countries. In this regard, the attitude that U.S. authorities will adopt following the various accounting scandals that have arisen will play a major role in allowing or preventing the emergence of truly harmonized global standards.

Although significant progress has been achieved to date, some current trends in international standard-setting are a source of considerable concern, in terms of the objectives being pursued, the manner in which standards are produced and the results that derive therefrom.

The objectives being pursued place excessive focus on the short term and complicate the task of financial communication. Despite a constant lack of support from a majority of players and a risk of increased volatility, especially in results and stock prices, the International Accounting Standards Board (IASB) is seeking to impose fair value accounting regardless of the holding periods or management processes involved. This approach fails to sufficiently take into account the specific features of the items being valued and the limited relevance of the concept of a "market" for certain of these items, since in some cases all that is available is a theoretical valuation model.

The manner in which the standards are drafted often reflects both a lack of understanding of the difficulties encountered by those applying them and verifying compliance, and of the need to develop common standards that are applicable at the European and global levels. The IAS standard setting process remains unsatisfactory because not enough attention is paid to the views expressed by concerned parties. The ways in which the IASB determines its agenda and proposals, and the validations that they are subject to, all call out for reform.

Without a global and concerted vision of the purposes and content of standards, what we risk obtaining is complex, detailed and ultimately opaque financial information, rather than synthetic ("*synthétique*") disclosures on performance and sensitivity to risks that can meet the needs of the various users of financial statements.

(1) International Accounting Standards / International Financial Reporting Standards.

In response to these trends, the working group issues the following recommendations to standard-setters and regulators:

① – As a basic principle, avoid balance sheet volatility and build on what has already been achieved

The aim of financial information is to meet criteria of quality. This means not creating artificial volatility of balance sheet data, and providing relevant and reliable information. Following on from the major progress achieved in the area of standardization, reaching these goals is now a matter of strengthening what is already in place, rather than departing into approaches that are at variance with the real economy and fail to offer the necessary prudence in valuations.

- ***Taking into account holding periods and management processes, particularly for long-term assets and liabilities***

Financial information standards for determining results must be tailored to the planned holding periods and to management processes. They should meet the needs of long-term investors, but also provide data on short-term valuations of certain items for comparison purposes, when these are relevant.

- ***Emphasizing the definition of indicators rather than frequent individual valuations***

Instead of seeking to impose accounting based on fair value or market value, which will necessarily be illusory or even misleading in the absence of reliable, consistent and comparable reference data, it would be far more profitable to focus on defining indicators, particularly indicators of sensitivity to certain market risks.

- ***Clarifying and harmonizing the information used***

Lastly, due to the inflation in data requirements, it is essential that standard-setters refocus their work on the key items of greatest interest to the users of financial statements. Indeed, what matters is that the data they use today be clearly defined and presented in a synthetic ("*synthétique*") fashion, particularly as regards off-balance-sheet items, risks and income data (e.g. operating income).

② – Reassess the process by which International Accounting Standards are drafted and approved

Drawing up a single set of standards should require taking into account the European environment and adhering as much as possible to principles that are universally applicable and accepted.

- Defining and explaining clear principles

During the drafting process and in the standards themselves, the core principles at play and the approach selected must be clearly identified and presented. Focusing on these core principles will avoid the development of overly detailed and complex rules, with all the difficulties and risks that applying them and verifying compliance would entail.

The standards that are adopted must in any event allow assessment of a company's potential, liabilities and operations, and the material risks and uncertainties related to elements and activities of the business.

- Giving Europe the place it deserves in international standard-setting

The process by which International Accounting Standards are elaborated needs to be reformed so as to give Europe its rightful place in international standard-setting and to define a common global set of standards.

Emphasis should be placed on convergence between U.S. GAAP and IAS/IFRS, particularly as regards such project areas as business combinations and disclosure of results. The aim should be to seek unconditional acceptance of the IAS/IFRS by the United States.

The process by which standards are approved at the European level should ensure that European companies are not hampered by competition-distorting requirements, which could call into question the adoption in Europe of IAS/IFRS standards not recognized in the United States.

- Developing the dialog among issuers, investors and auditors with a view to achieving relevant, reliable and verifiable financial information

In order to develop applicable standards yielding relevant, reliable and verifiable financial information, the IASB's working procedures need to be reformed to better take into account the views expressed by all economic players, particularly issuers, investors and auditors. This assumes that companies will devote the necessary financial and human resources to this process.

Improving the IASB's "due process" should involve agenda-setting debates, broad distribution of documents submitted to the board, implementation tests for the solutions being considered and sufficiently long comment periods (e.g. 6 months for complex projects).

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CONCLUSION

Since the first Viénot report, French companies have developed and to a large extent put into practice a particularly thorough set of rules of corporate governance. They also carry on business within a legal and regulatory framework that provides further protection against many forms of excess. But given the extent of the turmoil and confusion that has followed certain cases of fraud in the United States or strategic and financial failures in France, the recommendations contained in this report may prove useful.

The report's recommendations on corporate governance or financial disclosures depend for their implementation on each company's individual decisions. As far as listed companies are concerned, the working group recommends that its proposals be implemented as rapidly as possible and at the latest by the end of 2003. In accordance with the terms of the Viénot II report, the annual report should include a discussion of to what extent the recommendations in the present report have been implemented.

All of the issues discussed in this report in relation to French companies are international in scope. The working group is convinced that the globalization of markets will necessarily lead sooner or later to a standardization of rules at the global level.

The recent adoption of new U.S. legislation on corporate governance, the Sarbanes-Oxley Act, which has an impact on European companies listed in the U.S., illustrates just how much Europe needs to speak with a strong and single voice to avoid the risk that regulation be carried out unilaterally by the United States. In these areas, French companies intend to be proactive promoters of change, as this report exemplifies.

Appendices

- Mission letter (in French)
- Membership of the working group

AFEP-AGREF
Le Président

MEDEF
Le Président

Monsieur Daniel BOUTON
Président Directeur Général de la
SOCIETE GENERALE
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92972 PARIS LA DEFENSE 7

Paris, le 22 avril 2002

Monsieur le Président,

Les répercussions de l'actualité internationale font apparaître la nécessité de se pencher à nouveau sur un certain nombre de principes relatifs au gouvernement d'entreprise, à l'information et la communication financières ainsi qu'à la pertinence des règles comptables. D'importants travaux de place, déjà réalisés au cours des dernières années, ont entraîné de substantielles évolutions dans la gouvernance des entreprises et la notoriété de la place financière de Paris. Il s'agit aujourd'hui de mesurer si, à la lumière d'événements récents au retentissement mondial, l'adéquation entre l'attente des investisseurs et des marchés, d'une part et l'ensemble du corpus de règles, normes et comportements, d'autre part, reste satisfaisante.

Dans cet esprit, nous vous remercions vivement d'avoir accepté de présider un groupe de travail chargé d'examiner notamment les questions suivantes :

- l'amélioration du fonctionnement des organes de direction des entreprises, en particulier du comité d'audit ;
- la pertinence des normes et pratiques comptables ;
- la qualité de l'information et de la communication financières ;
- l'efficience des contrôles internes et externes (auditeurs et régulateurs) ;
- les relations des entreprises avec les différentes catégories d'actionnaires ;
- le rôle et l'indépendance des acteurs du marché (banques, analystes financiers, agences de notation…).

La question majeure du rôle et de l'indépendance des auditeurs sera examinée par le comité d'éthique du MEDEF présidée par M. René Barbier de La Serre qui participera par ailleurs à vos réflexions. Les propositions de ce comité seront versées aux travaux que vous mènerez.

Ce groupe de travail procédera aux auditions qu'il jugera nécessaires. Ainsi que nous en sommes convenus, M. Bernard Field assurera la fonction de Rapporteur Général et bénéficiera du concours d'un comité technique.

Il serait souhaitable de disposer de vos conclusions d'ici la fin juillet, compte tenu des réflexions en cours aux niveaux national et international et notamment des travaux européens.

En vous renouvelant nos remerciements les plus vifs, nous vous prions d'agréer, Monsieur le Président, l'expression de nos sentiments les meilleurs.

Bertrand COLLOMB

Ernest-Antoine SEILLIERE

Membership of the Working Group

Chairman : Daniel BOUTON, Chairman and Chief Executive Officer of SOCIETE GENERALE

Members : Euan BAIRD, Chairman and Chief Executive Officer of SCHLUMBERGER
Thierry BRETON, Chairman and Chief Executive Officer of THOMSON MULTIMEDIA
René BARBIER de LA SERRE, Chairman of the Committee on Ethical Questions of MEDEF
Jean-Dominique COMOLLI, Co-Chairman of ALTADIS
Jean-Martin FOLZ, Chairman of the Management Board of PEUGEOT S.A.
Denis KESSLER, Chairman of the Fédération Française des Sociétés d'Assurance (FFSA) (French Federation of Insurance Companies)
Igor LANDAU, Chairman of the Management Board of AVENTIS
Gérard MESTRALLET, Chairman and Chief Executive Officer of SUEZ
Edouard MICHELIN, *Co-Gérant des Etablissements MICHELIN*
Jean PEYRELEVADE, Chairman of CREDIT LYONNAIS
René RICOL, Deputy President of the International Federation of Accountants (IFAC)
Serge TCHURUK, Chairman and Chief Executive Officer of ALCATEL
Serge WEINBERG, Chairman of the Management Board of PINAULT PRINTEMPS REDOUTE

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Rapporteur General : Bernard FIELD, Corporate Secretary of COMPAGNIE DE SAINT-GOBAIN

Deputy Rapporteur General : Patrick SUET, Deputy Corporate Secretary of SOCIETE GENERAL

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Technical Committee

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Joëlle SIMON
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<u>AFEP</u>
Patrick ROCHET
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