

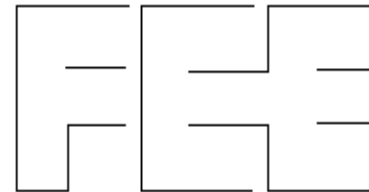
Date  
10 February 2004

Le Président

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Ms. Veronique Ingram  
Chair  
OECD Steering Group on Corporate Governance  
Corporate Affairs Division



Dear Ms. Ingram,

**Re: Draft Revised Text OECD Principles of Corporate Governance**

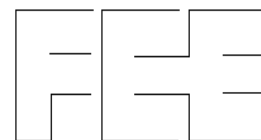
FEE (Fédération des Experts Comptables Européens – Federation of European Accountants) as the representative organization for the accounting profession in Europe grouping together 41 professional bodies in 29 countries representing over 500.000 individuals, is pleased to have the opportunity to comment on the revised OECD Principles of Corporate Governance. We welcome the revision of the OECD Principles. The current environment and recent corporate scandals show again the importance of proper corporate governance. FEE itself underlined the key role of corporate governance in our discussion paper of September 2003 on the Financial Reporting and Auditing Aspects of Corporate Governance (copy enclosed). Other relevant recent FEE papers to which we would like to draw your attention are our discussion paper on the Enforcement of IFRS within Europe of April 2002 and our paper on A Conceptual Approach to Safeguarding Integrity, Objectivity and Independence Throughout the Financial Reporting Chain of November 2003 (copies enclosed).

The main issues we address in this letter concern:

- Reduction of information risk through appropriate disclosure.
- Need to adopt the Principles within the context of the applicable laws and regulations of each individual country.
- Emphasis on the “comply or explain” approach.
- Responsibility of the board for financial reporting, risk management and internal control.
- More emphasis on the role and responsibilities of non-executive directors.
- Voluntary corporate governance codes allows for adaptation to new trends and issues.
- Role of the internal audit function needs to be elaborated.
- Questions to the external auditor to be put in context.
- Independence of external auditors.

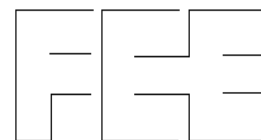
General

1. We believe it is very important to draw a distinction between information risk, by which we mean the risk that stakeholders are not given sufficient, accurate information on which to base their decisions, and underlying investment or business risk, meaning the risk inherent in a particular activity or the risk appetite of the business’s management team. We suggest that it is a fundamental principle that corporate governance requirements should be designed so as to (a) reduce information risk to stakeholders by ensuring that there is appropriate disclosure and (b) ensure that the organisation’s business risks are properly managed. In the latter case, risk management should be set in the context of the on-going need to take calculated risks and make investments to generate profits and ensure the future prosperity of the organisation. We recommend that this principle, which is recognised by regulators in many countries but often overlooked when setting detailed requirements, should be explicitly stated in the OECD’s guidelines.



2. FEE appreciates that OECD takes into consideration the different national corporate governance systems and that the principles are built up in respect to one-tier and two-tier systems which are treated as equivalent systems. FEE explicitly appreciates the remarks in the preamble on the term “board” used in the document. That is, in a two tier system, the term “board” refers to the “supervisory board” while “key executives” refers to the “management board”. In a unitary system the term “board” includes both. However, we doubt whether the responsibilities given to the “board” do in all cases and jurisdictions with a two-tier system appropriately reflect the responsibilities of a supervisory board, or whether they encompass at least in certain cases also tasks which would be within the responsibility of the management board (e.g. principle V.D.1. where it is stated that the board should set performance objectives, or principle V.D.7 where it is stated that the board should ensure the integrity of the corporation’s accounting and financial reporting systems). We therefore suggest that in the Preamble to the Principles to state that, where relevant, the Principles need to be adapted within the context of the applicable laws and regulations of each individual country.
3. In the current environment and the demise of a number of important companies all over the world it has become evident that risk management and internal controls are crucial elements in the corporate governance and the success of business. It is of concern to us that these aspects are hardly addressed in the Principles and annotations.
4. The Principles should recognise more clearly that there is rarely a single model of governance that fits every business, which is why many countries have adopted a “comply or explain” approach. This would require companies to disclose departures from the corporate governance code applicable to them so that a departure should not per se be regarded as negative, as long as it is fully explained. Further, it is for the stakeholders, not the regulators, to decide on the basis of the explanation given whether the departure from the corporate governance code is acceptable. The role of the regulator is to decide whether the explanation is sufficient to allow stakeholders to form that view. We believe this principle should be explicitly stated in the OECD paper. Again in our Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance (as enclosed), we emphasized the use of disclosure as a powerful regulatory tool.
5. We are of the opinion that the principles should make clear the responsibility of the board (executive and non-executive directors, management and supervisory board) for financial reporting. It should also be made clear that the board (or in the case of two tier boards, the management board) is responsible for their company’s systems of risk management and internal control. These individuals are the first line of defence for the financial statements, internal control and risk management and not the (external) auditor.
6. The role and responsibilities of non-executive directors in a unitary system and the members of a supervisory board in a two-tier system – more and more important in the current climate – should have been addressed in more detail in the Principles including what constitutes independence. We refer in this respect to our papers mentioned in paragraph 4.
7. The annotations on page 15 address the status of corporate governance codes and contain rather negative wording about the voluntary status of corporate governance codes. We believe the emphasis should be more positive. Corporate Governance must evolve, able to respond quickly to new trends and issues. In many countries the legislative processes are too slow to assure such responsiveness and non-statutory codes have developed as a result. There is no evidence such codes are any less well enforced than their statutory equivalents, but several countries have examples of statutory arrangements failing to keep up with business trends. Furthermore voluntary codes are often subject to some form of endorsement or recognition, by stock exchanges, regulators or governments.

However, we agree that for transparency and comparability reasons there should be only one corporate governance code at the national level applicable to a company, that is that the company cannot choose which code it would like to follow. In this respect, FEE supports the conclusions of the Jaap Winter Report and the European Commission Communication on Company Law and

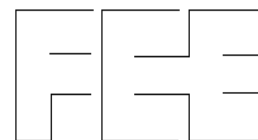


Corporate Governance that there is no need for a separate European Corporate Governance Code in legislation, but that codes should be developed at national level and that only some principles and common benchmarks should be part of the European legislation, as also recommended in the Jaap Winter report.

8. The role of the internal audit function in corporate governance can be misunderstood. We find it essential that the OECD Principles are compatible with modern views as expressed by the Institute of Internal Auditors and elsewhere such as in the work of COSO, however some language in the draft may give another impression. Although in the external auditors' perspective internal audit is part of the internal control framework, internal audit must not be seen as a substitute for proper systems of internal control which should be in place and operating effectively whether or not there is an internal audit function.

#### Detailed Comments

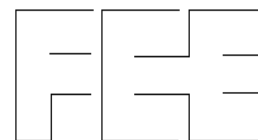
9. Principle I.C.2. states that shareholders should have the opportunity to ask questions to the external auditor. We believe that there are a number of practical issues that need to be carefully considered before the text of the Principles is finalised, and we would therefore ask the OECD to make the necessary changes to the text.
  - There are some jurisdictions with two-tier board systems (such as Germany) where the external auditor is accountable to the representatives of the shareholders and other relevant stakeholders on the supervisory board. In these jurisdictions, the issue of questions to the external auditor will need to reflect the law in their respective countries.
  - It should be remembered that those people within the company who are charged with the governance (i.e. the directors) of the organisation are the individuals who are responsible for the preparation, approval and ownership of the financial statements. Questions related to the financial statements as well as the future development and viability of the company and other such matters should be addressed to the relevant directors and not the external auditors.
  - The auditor has to deal with issues of professional obligations and duties related to client confidentiality. This is regulated in law in some Member States and caution needs to be exercised to ensure that conflicts are not created.
  - We therefore strongly recommend making Principle I C 2 more precise. In those countries where shareholders should rightly have the opportunity to ask questions of the external auditors, that the questions should not cover areas that are properly the responsibility of the company, but be limited to the responsibilities of the external auditor, the audit work performed and the auditors' report.
  - The OECD should also be careful to ensure that such a shareholders' right does not result in any change of the current liability regimes which – due to different legal systems, traditions etc. – should be a national rather than a European or global issue.
10. Principle IV: In the opening sentence of Principle IV reference is made to the “timely and accurate disclosure” of information. We recommend that the word “accurate” be replaced by the word “fair”. “Accurate” implies a level of precision that is frequently not possible in either financial statements or other information provided to shareholders and other stakeholders. Indeed, accuracy can be at the expense of fairness in some circumstances and we believe that information should be provided in a manner which does not advantage one group of users over another and is in that sense “fair”.
11. Principle IV.A.2 requires the disclosure of company objectives. The annotations should provide clarification as to what can be expected from companies in order to avoid boiler plate wording. Indications could include information about the company's strategy and risk profile. A.8. requires the disclosure of governance structures and policy but does not refer to practices and disclosure on



performance, which would be much more relevant information, as further detailed in our general comment on the previous page.

12. Principle IV C/D: The terminology used for the auditor is confusing and it would be helpful if the auditor could be referred to as “external auditor” everywhere.
13. Principle IV.C indicates that the audit of financial statements exists to provide an assurance to the board and to the shareholders. Although we would agree that in practice the audit can be a valuable tool for the board, in most countries the recipient of assurance is the shareholders. There are however some countries with two-tier boards and their own individual laws and corporate governance requirements (such as Germany) where the primary recipients of assurance are the representatives of the shareholders and other relevant stakeholders on the supervisory board. This difference should be reflected in the wording of the text.
14. Principle IV.D: On the same grounds as referred to in Principle IV C (above) the principle should be clarified in a similar way. External auditors are in most countries accountable to the shareholders whereas in some countries (such as Germany) the auditor is responsible to the representatives of the shareholders and other relevant stakeholders on the supervisory board. This difference should similarly be reflected in the wording of the text. The term accountability also needs clarification in that it means a reporting responsibility of the external auditor for his work, taking into account the different national liability regimes. It would also be useful if the principle could be elaborated to make clear that boards are expected to cooperate with the external auditor. In the interest of audit quality, directors and management should be under some form of (legal) obligation to disclose truthfully to external auditors any information, which may be specifically relevant to the audit, such as perhaps instances of fraud and accounting error without the external auditors specifically enquiring (since they may be unaware of such issues arising).
15. The Annotations to Principle IV should make explicit reference to the necessity for all the parties in the supply chain for financial reporting, which includes management, the (supervisory) board and their advisors (including lawyers, banks and analysts), to have a legal duty to act in the public interest in respect of the provision of financial information.
16. Page 32 of the annotations gives further clarification of Principle IV.C. It says: “Provision of non-audit services by the external auditor to a company can significantly impair their independence and might involve them auditing their own work”. We regard this as too strong a statement that may be misinterpreted in isolation as suggesting that all non-audit services can lead to significant impairment of independence. There are many services provided by auditors which have no bearing on their independence and indeed which contribute to the quality of their audit. This is why regulators in many countries who have studied the issue have avoided assertions of this type.

Objectivity, as assured through independence, is one of the fundamental principles to be observed by the external auditor. External auditors are required and certainly expected to provide other assurance services as well as statutory audit of the financial statements. The risk to the auditors’ independence and possible safeguards which may arise from provision of other services is addressed in our codes of ethics. The external auditor must conscientiously consider whether a non-audit engagement involves threats, which would, either in fact or in appearance impede the observance of this fundamental principle. Where such threats exist the external auditor should put safeguards in place that eliminate the threats or reduce them to clearly insignificant levels. If the external auditor is unable to fully implement adequate safeguards, he should refrain from acting. This approach prohibits relationships and situations, including the provision of those non-audit services which compromise auditors’ objectivity and is also enshrined in the IFAC Code of Ethics and the EU Recommendation on Statutory Auditor Independence. The IFAC Code of Ethics is now to be revised under oversight of the PIOB (Public Internal Oversight Board) with members of regulatory and public interests groups such as IOSCO, Basel Committee Banking Supervisory Board, EC, World Bank and the International Association of Insurance Supervisors. The IOSCO statement on Principles of Auditor Independence of October 2003 also supports such a principles based approach. Also the Financial Stability Forum (FSF) underscored the need for strong auditor



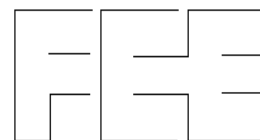
independence and public oversight arrangements to restore confidence in the integrity of the financial reporting framework. They urged relevant authorities and concerned parties to ensure the speedy implementations of IOSCO's principles. We also refer you to FEE's position on auditor's independence (copy enclosed) that gives detailed arguments why a blanket prohibition of non-audit services is inappropriate and misguided in most places.

We therefore suggest the sentence to read: "Provision of non-audit services by the external auditor to a company can provide a threat to his independence and can only be undertaken if sufficient safeguards are put in place to eliminate such a threat, or reduce it to an insignificant level".

17. The same page also mentions as an example of underpinning auditor independence mandatory firm rotation to avoid a perceived familiarity risks. Several studies have evidenced – United States General Accounting Office – Report to Senate Committee November 2003; UK Coordinating Group on Audit and Accounting Issues Final report, 29 January 2003, SDA Università Bocconi, The impact of mandatory audit rotation on audit quality and on audit pricing: The case of Italy, 2002, etc- that the negative consequences of external rotation outweigh the potential benefits. External firm rotation leads to a loss of cumulative audit knowledge and increases the risk of audit failure in the first years after rotation. FEE supports the rotation of key audit partners as foreseen in the EC Recommendation on Statutory Auditors' Independence and the IFAC Code of Ethics. We therefore strongly suggest deleting the text between brackets and to replace "mandatory rotation of auditors" by "mandatory rotation of key audit partners".
18. Page 33 of the annotations gives further clarification of Principle IV.D. It refers to the practice that external auditors are recommended by an independent audit committee or equivalent body. In a number of countries the law requires prior intervention of other bodies such as for instance the Workers Council in such recommendation or appointment. Therefore it would be better to refer to "another body" instead of to "an equivalent body".

The last sentence of the paragraph refers to the external auditor having a duty of care to the company as a whole and not to an individual or group of corporate managers, which we fully support. This sentence could be further clarified by not only referring to any individual or group of corporate managers but also to any specific group of shareholders.

19. Principle IV.C states that a Board should apply ethical standards. We believe that the principle, or at least the annotations should more specifically address the integrity of management and board members. As set out in our papers, "Discussion Paper on Enforcement of IFRS within Europe" and "FEE Paper: A Conceptual Approach to Safeguarding Integrity, Objectivity and Independence throughout the Financial Reporting Chain" each participant in the corporate reporting chain should have proper industry codes and practices including a clear ethical obligation to raise issues of concern.
20. Principle V.D.7. and the corresponding annotations on page 37 of the annotations seem to imply that the audit is part of the financial reporting system, which is confusing the responsibilities of the board and the external auditor. We therefore recommend replacing the word "including" with "and". Audit should be seen as distinct of the accounting and financial reporting system, be it that they form all parts of the enforcement system. It would also be helpful to split D.7. into two separate points, the second point being on systems of control.
21. Principle V.E.3. and page 40 of the annotations say that board members should be able to commit themselves effectively to their responsibilities. This Principle should address the need for the board members to have the experience and competence to fulfil their responsibilities to their company. The Sarbanes-Oxley Act, Jaap Winter Report, and our Discussion Paper on Corporate Governance include similar requirements.



We would be pleased to discuss any aspects of this letter you may want to raise with us.

Yours sincerely,

David Devlin  
President

Encl:

FEE Discussion Paper “The Financial Reporting and Auditing Aspects of Corporate Governance” and related press release

FEE Discussion Paper “The Enforcement of IFRS Within Europe” and related press release

FEE Discussion Paper “A Conceptual Approach to Safeguarding the Integrity, Objectivity and Independence Throughout the Financial Reporting Chain” and related press release

FEE’s Position on Auditor’s Independence