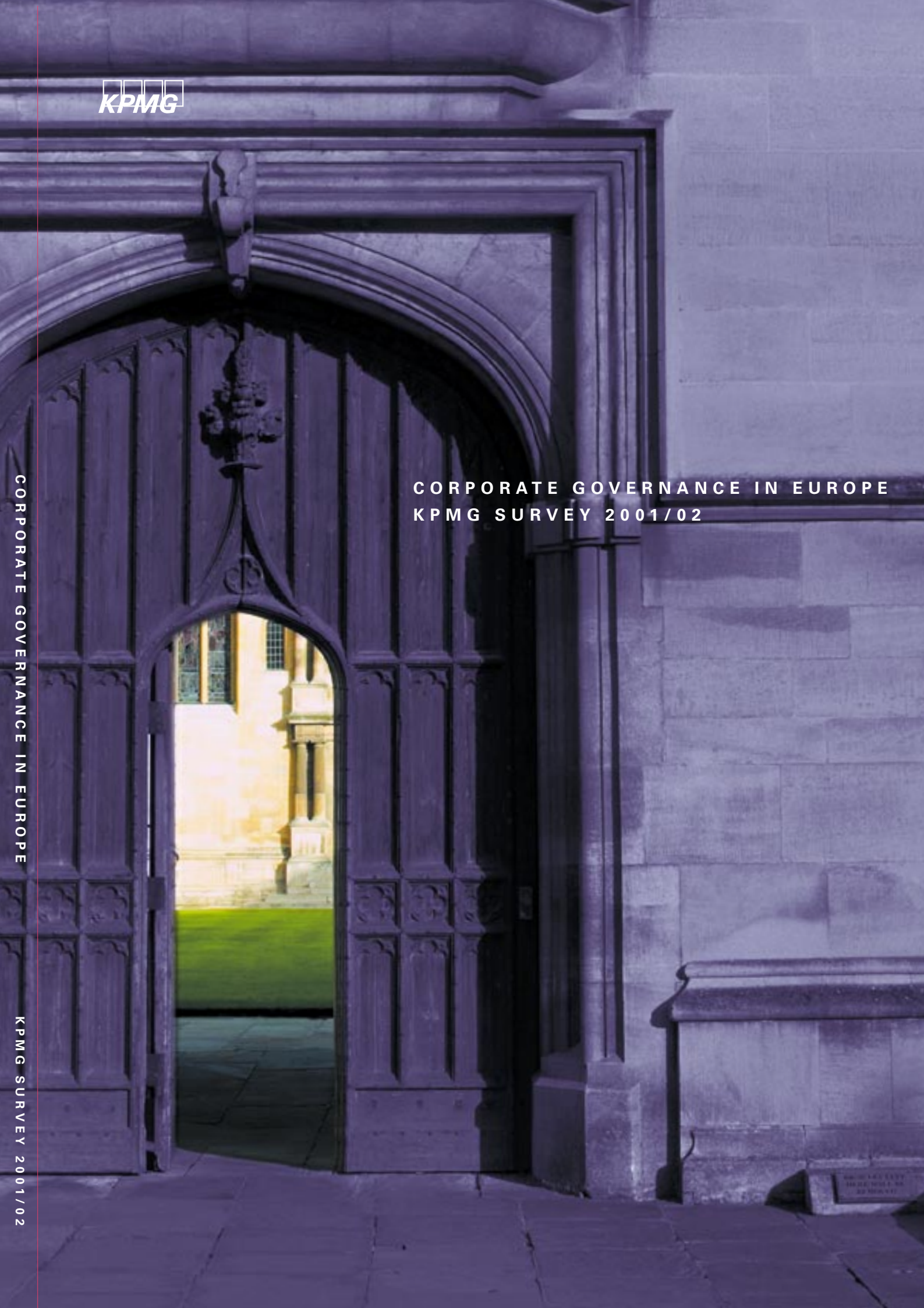




CORPORATE GOVERNANCE IN EUROPE  
KPMG SURVEY 2001/02

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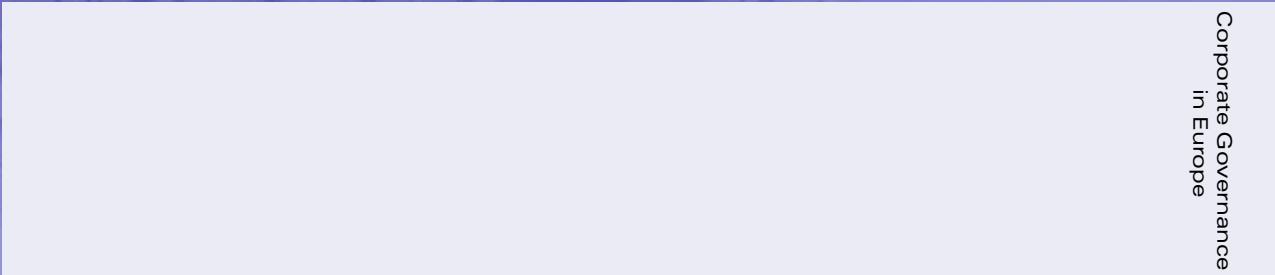
# Contents

<b>Highlights</b>	3
<b>1 Introduction</b>	5
<b>2 Background and methodology</b>	9
<b>3 The board</b>	11
3.1 Chairman and chief executive officer	12
3.2 Board balance	13
3.3 Independence	13
3.4 Stakeholder representation	16
3.5 Experience	17
3.6 Board size	18
3.7 Frequency of board meetings	19
3.8 Attendance at board meetings	20
3.9 Duration of board meetings	21
3.10 Evaluating boards, audit committees and chairmen	21
<b>4 Specialised committees</b>	23
4.1 Audit committees	24
4.2 Remuneration or compensation committees	30
4.3 Nomination committees	32
<b>5 Internal control and risk management</b>	35
5.1 Responsibility for the system of internal control	36
5.2 Risk awareness	37
5.3 What is the system of internal control?	37
5.4 Risk identification and evaluation	39
5.5 Embedding the system of internal control and risk management	40
5.6 Reviewing the system of internal control and risk management	40
5.7 Does risk management add value?	41
<b>6 Internal and external audit</b>	43
6.1 Existence of internal audit	44
6.2 Communication between auditors and the audit committee	44
6.3 Relative values of internal and external auditors	45
<b>7 Belgium</b>	47
<b>8 France</b>	53
<b>9 Germany</b>	59
<b>10 Ireland</b>	67
<b>11 Italy</b>	71
<b>12 Netherlands</b>	75
<b>13 Switzerland</b>	83
<b>14 United Kingdom</b>	89
<b>Appendix</b>	99
Useful Web sites	100





# Highlights



Corporate Governance  
in Europe

## Highlights

- In the United Kingdom, high standards of governance are now seen to be beneficial and there is wide acceptance of best practice in the majority of listed companies. Elsewhere in Europe, corporate governance is generally seen as a developing area and we expect increasing compliance with applicable codes of best practice.
- Evaluation of executive directors and audit committees is more prevalent in the Netherlands than elsewhere in Europe. Few Belgium boards and audit committees are regularly evaluated. (Section 3.10)
- As a consequence of the two-tier system in Germany and the Netherlands, the number of companies that have established an audit committee lags behind other European companies. In the United Kingdom, audit committees are more widespread and contain a higher proportion of independent directors than elsewhere. (Section 4.1)
- In the Netherlands, audit, remuneration and nomination committees are sub-committees of the supervisory board and therefore should consist exclusively of independent directors. However, respondents considered relatively few committees to be independent. We believe this is because executive directors and others often attend committee meetings and have therefore been reported as members. (Section 4.1)
- Boards appear to be aware of the significant risks, and to a slightly lesser degree, the significant opportunities facing their companies. However, in all countries other than the United Kingdom, a small minority of respondents were unsure as to whether the board were fully aware of the significant risks. (Section 5.2)
- Systems of internal control and risk management were generally considered to be highly embedded. In Germany, 95% of respondents considered controls to be embedded, at the other extreme, the Netherlands (69%). (Section 5.5)
- Over 60% of respondents believed that their systems of internal control and risk management add value to their organisation. (Section 5.7)
- Around 85% of respondents from the United Kingdom and Germany reported the existence of an internal audit function. This is to be expected as both the Turnbull report and KonTraG give a strong steer in this direction. However, many respondents, particularly in Belgium, Switzerland and the Netherlands, do not have such a function. (Section 6.1)
- Internal auditors are generally considered to be more communicative than external auditors on matters such as business strategy, the risks facing the business, the system of internal control, social, ethical and environmental matters, and fraud. By contrast, external auditors are considered more communicative than internal auditors on issues such as accounting policies, the financial statements and auditor independence. (Section 6.2)
- Generally external auditors appear to be less valued than their internal audit counterparts in each of the five categories - respected within the organisation; seen as a value adding resource; business objective orientated; sounding board for directors; and training ground for senior management. Nevertheless, there are some important national trends. (Section 6.3)

# 1

## Introduction

## Introduction

Although corporate governance is considered to be a relatively new topic, corporate governance practices are well established. Governance issues arise whenever an enterprise acquires a life of its own ie, whenever ownership of an entity is separated from its management. Adam Smith demonstrates that the concept of corporate governance was understood in the eighteenth century, even though the phrase was not in use:

*“The directors of companies, being managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.”<sup>1</sup>*

So what is corporate governance? There are many different definitions, but a useful one is that set out in the Principles of Corporate Governance developed by the Organisation for Economic Co-operation and Development (OECD) in 1999.

*“Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation ... and spells out the rules and procedures for making decisions on corporate affairs. By doing this it provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.”<sup>2</sup>*

Put simply, corporate governance is the umbrella that covers the way in which companies are directed and controlled. The issue is two-fold. It concerns both the effectiveness and the accountability of boards of directors.

The effectiveness of boards - and therefore the quality of leadership and direction that they provide - is measured by performance. Ultimately by enhanced shareholder value.

Accountability - including all the issues surrounding disclosure and transparency - is what provides the legitimacy to the classic model public company. Shareholders elect directors to run companies on their behalf

- *ipso facto*, boards are accountable to shareholders for their actions.

Across Europe, different countries have adopted different governance approaches due to historical, economic and cultural differences. For example, in France, the Président Directeur Général (PDG) wields formidable power and deals with much of the day to day business operations. By contrast, in the Netherlands and Germany control and management is separated through two tier boards which can be traced back to the Dutch East India Company of the 17th century and the Bismarck reforms of the 19th century.

### Towards convergence

With the emergence of global markets today’s investors are becoming increasingly active and demand higher standards of accountability, behaviour and performance than their predecessors - their influence on the world’s boardrooms is on the increase.

Governance structures are under pressure from cross-border investment with investors increasingly seeking opportunities outside their domestic markets. Companies raising funds in international capital markets are finding that capital is only available to those that meet internationally accepted standards of governance and disclosure.

These are just some of the reasons why governance standards across the world are improving, and to some extent converging. But, before considering how convergence is taking place, it is important to look first at some of the economic and cultural differences that have given rise to the governance models that exist today.

Historically, there are broadly two approaches. One approach is characterised by large liquid capital markets, a growing concentration of power within institutional investors, and an active takeover market. By contrast, the other approach is characterised by less liquid markets and a greater concentration of power with banks, families, employees, and governments.

<sup>1</sup> Adam Smith, *The Wealth of Nations*, 1776.

<sup>2</sup> OECD, *OECD Principles of Corporate Governance*, 1999.

Banks play an important role in Germany where borrowings have historically proved more important than equity as a source of external finance. In the two-tier board system, banks are often represented on the supervisory boards that are responsible for overseeing the company. They also own large amounts of equity in many listed companies.

In France, the government is an important stakeholder - partly as a result of the states direct shareholdings in French industry, and partly due to the circulation of senior executives between the civil service and the boardroom.

In both the Netherlands and Germany, statute ensures that employees play an important role in corporate governance through their direct, or indirect involvement, with works councils and supervisory boards.

If one model promotes the interests of shareholders, the other arguably encourages greater attention to the long-term development of industry as a whole.

In the United Kingdom, it is the primacy of shareholders that is paramount, albeit that this can be achieved only through directors having regard to the other relationships on which the company depends - such as those with employees, customers, suppliers and the community, as well as to the impact of business decisions on the company's reputation and the environment. However, there have been concerns in recent times that the pendulum has swung towards short-termism and directors have neglected long-term prosperity in favour of more immediate profits. For this reason, Company Law Reform is seeking to re-establish the equilibrium and ensure that both short and long term views are evaluated in determining company success.

On the other hand, in countries such as France, Germany and the Netherlands, companies are customarily seen as having a social as well as an economic purpose. The different philosophy is most notably illustrated by the two tier board structure which while optional in France, is adopted universally in Germany and the Netherlands. While perhaps more bureaucratic and rigid than a unitary board, many would argue that there is merit in clearly distinguishing the supervisory and management roles.

The distinction between the aforementioned approaches is, however, beginning to weaken and we are seeing signs of convergence.

In the United Kingdom, management and investors are moving away from short term profit horizons. More than ever before, companies are recognising the importance of the wider group of stakeholders in sustaining long-term prosperity for shareholders. Increased links between directors' remuneration and long-term performance is one of the key drivers here. It would be naive to suggest that directors' and shareholders interests are aligned in all United Kingdom listed companies, but at least directors' remuneration is more transparent than it was a few years ago.

While the United Kingdom is arguably moving away from the short-term perspective, the converse is true in some other European countries where long and short term views are converging.

## Rules, regulations and guidance

Against this background, many countries have specific rules, regulations and guidelines on corporate governance. The Cardon report in Belgium, the Peters report in the Netherlands, the Combined Code in the United Kingdom and Viénot in France to name just a few. Other countries, for example Germany and Switzerland, are in the process of developing authoritative codes of best practice.

The approach taken by many of these codes and guidelines is similar. Perhaps this is not surprising since boards carry broadly similar responsibilities within whatever form of corporate structure they are working - in general terms, governance is about board accountability and board effectiveness the world over.

Our study examines many of these themes and identifies the extent to which various recommendations and guidelines have been implemented in practice. In chapters 7 to 15, we have also included a brief discussion of the corporate governance regime in each of the countries participating in our study.

## Where now for corporate governance?

The introduction of the Turnbull report in the United Kingdom has changed the role and focus of risk management in many listed companies. Before Turnbull, a few companies, the pioneers, already had sophisticated risk management processes and systems of internal control. But for most listed companies, Turnbull has helped raise awareness of, and established the need for, risk management. Boards are now significantly more involved in risk management and there is widespread, though by no means complete, acceptance that disciplined risk management is central to good corporate governance.

The Turnbull guidance has also had an impact outside the United Kingdom - and not only in overseas subsidiaries of companies listed on the London Stock Exchange. As global markets emerge, investors are increasingly demanding higher standards of accountability, behaviour and performance. Turnbull is good for business and good for those investing in business - that is why it is of interest to investors, regulators and standard setters not only in Europe, but the world over.

Additionally, European law makers are also becoming increasingly influential in the development of uniform governance standards. The European Commission are already engaged in a comparative study of European corporate governance.

Finally, during the last few years, Europe has witnessed increasing levels of shareholder activism. The link between corporate governance and performance has not yet been proven beyond doubt, but institutional investors are increasingly making some sort of connection and are no longer backward in voicing their opinions.

With calls for voting to be made compulsory, it would seem that even in highly developed capital markets, shareholder responsibility and the whole governance debate still has a long way to run.

# 2

## Background and methodology

## Background and methodology

### Background

The emergence of global markets and the most uncertain economic future that we have faced for many years means that the performance of both executive and non-executive directors and the way in which companies are directed and controlled will come under increasing scrutiny.

Those of you who have taken part in our previous corporate governance initiatives will know the pride we take in these and how keen KPMG is to help individual directors, boards, and businesses in general, rise to the challenges they face. This may mean new ways of working and new priorities.

So that we could improve our understanding of the impact of these challenges, we have undertaken a survey of the largest and most important companies in Europe to explore their views on a number of issues including:

- Board structures (including the skills and experience of directors)
- The role and definition of independent directors
- The evaluation of board members
- Audit, remuneration and nomination committee practices
- Risk awareness and the value of systems of internal control and risk management
- Communications between auditors and audit committees.

### Methodology

Our research was conducted during July and August 2001 using a postal questionnaire. Two hundred and thirteen responses were received by the cut-off date.

This report summarises the most significant findings and includes, where appropriate, a brief interpretation of these findings. Our report also includes a brief discussion of the corporate governance regimes in those European countries in which the research was carried out.

Our sample was drawn from listed companies in eight European countries. The breakdown of respondents is shown below.

While there was a low response rate in some countries, this does not necessarily reflect the level of interest in corporate governance issues. Many companies told us that they receive a large number of surveys and therefore, as a matter of policy, do not respond to any.

#### Sample

	Belgium	France	Germany	Ireland	Italy	Netherlands	Switzerland	United Kingdom	Total
Top 500 companies (by market capitalisation)	3	24	10	4	3	6	10	14	74
All companies	22	41	22	4	4	32	60	28	213

3	The board	11
3.1	Chairman and chief executive officer	12
3.2	Board balance	13
3.3	Independence	13
3.4	Stakeholder representation	16
3.5	Experience	17
3.6	Board size	18
3.7	Frequency of board meetings	19
3.8	Attendance at board meetings	20
3.9	Duration of board meetings	21
3.10	Evaluating boards, audit committees and chairmen	21

## The board

### 3.1 Chairman and chief executive officer

It is generally recognised that there should be a clear division of responsibilities at the head of companies to ensure a balance of power and authority such that no one individual has unfettered powers of decision. For unitary boards, many believe that there is merit in separating the two key tasks at the top of each listed company - the running of the board (the chairman's role) and the executive responsibility for running the company's business (the chief executive officer's role). For two tier boards the problems are less acute.

Separating the posts of chairman and chief executive officer has for some time been encouraged in the United Kingdom. As long ago as 1992 the Cadbury report extolled the virtues of having a "clearly accepted division of responsibilities at the head of a company". The Belgium Code of Conduct, being highly influenced by United Kingdom corporate governance recommendations, is also strongly in favour of separation.

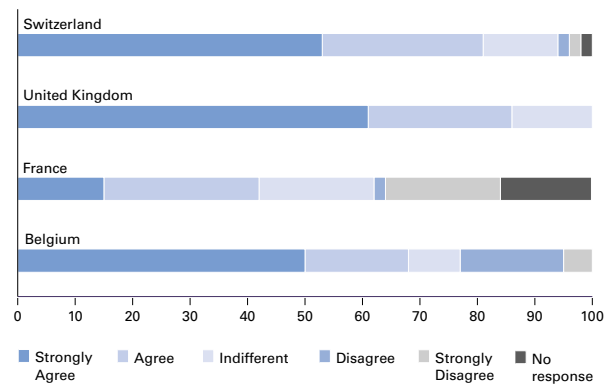
Germany and the Netherlands have two-tier boards and therefore the problems associated with a concentration of power within one individual are less acute. In two-tier boards, the management board is responsible for managing the company while the supervisory board is responsible for overseeing the management board.

French listed companies have the option of either a unitary board structure or a two-tier system similar to that adopted in Germany and the Netherlands. (28% of SBF 250 companies have adopted the two-tier system.) Until recently, the roles of chairman and chief executive officer were not separated in companies with a unitary board. Following the New Economic Regulations, separation is now an option. Separation was favoured by the AFG report, though the Viénot report maintained that companies should have the option to combine or separate.

We asked chairmen participating in our European survey for their thoughts about the separation of the chief executive officer and chairman roles and, in particular, whether they perceived a benefit in separation. The results are shown below.

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Separation of chairman and CEO



While unitary boards are prevalent in all four countries, there are significant differences between France, on the one hand, and Belgium, Switzerland and the United Kingdom. In each country, companies retain the option to combine or separate the chairman and chief executive posts (if appropriate for the specific enterprise), however, separation is more enthusiastically encouraged in Belgium, Switzerland and the United Kingdom.

### 3.2 Board balance

Boards can only exercise proper control if they are absolutely clear about their role and responsibilities - in effect, their *raison d'être*. For unitary boards, it is important that a clear dividing line exists between direction, which is the role of the board, and management which is the role of the executives. The distinction between direction and control is, however, a natural consequence of the two-tier board structure.

Virtually all corporate governance codes deal with who should, and who should not, be on the board. For unitary boards, most suggest a mixture of executive and non-executive (or outside) directors. This has the advantage of combining the executives' in-depth knowledge of the day to day affairs of the company with the wider experience of non-executive directors. The important thing is to ensure that directors should be selected on their merits, and for the greater good of the company as a whole. They should not, at least in theory, be selected to represent single interest groups to the detriment of others.

As long ago as 1995, the Viénot committee emphasised the importance of board composition and in 1999, in its second report, the committee set out that it is "every board of directors' duty to think about the balance desired for its composition and that of its supporting committees, and to periodically evaluate the effectiveness of its organisation and its operations in the performance of its tasks."

Board composition and balance is also addressed in the United Kingdom. The Combined Code (1998) states that "*the board should include non-executives of sufficient calibre and number for their views to carry significant weight in the board's decisions*".<sup>3</sup> This is also a recommendation of the Banking and Finance Commission in Belgium.

### 3.3 Independence

Most corporate governance codes recommend that boards should develop criteria for selecting board members who can bring independent judgement to bear on board issues. Of

course, independence is a judgmental issue and many corporate governance commentators have their own idea of what constitutes an independent non-executive director. What one person considers to be independent, the next person might not. However, it is reasonable to suggest that shareholders and other stakeholders expect independent directors to be free of personal and commercial connections with the company of which they are a director.

#### Definitions

Opinions may differ, but most people would agree that the following criteria are indicative of an absence of independence:

- former executive status;
- employee of the company;
- long-term association with the company;
- close family relationship with an executive director;
- representative of a major shareholder.

In the United Kingdom, the key consideration is independence from management - the most likely conflict is between the interests of those running the company, the directors, and those of the shareholders. It is recognised, however, that independence is a judgement call and therefore it is for boards to take a view on whether an individual director is independent.

After careful consideration, the authors of the Combined Code determined that it was not practicable to lay down precise criteria for judging independence, rather they adopted a loose definition set out in the earlier Cadbury report. Thus, in the United Kingdom, independent non-executive directors continue to be defined as those non-executive directors that are "*independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement*".<sup>3</sup>

In France, the definition of independence has been the subject of considerable debate. Both Viénot reports

<sup>3</sup> Committee of Corporate Governance, *The Combined Code*, 1998.

addressed this issue. The first report advised that any non-executive who had previously been an executive on the board could not be considered truly independent until three years had elapsed since he or she last held an executive position on that board. The later report relaxed this condition. It stated that “*directors are considered independent from the senior management of the company if they do not maintain any relations, of any nature whatsoever, either with the company, its subsidiaries, or its holding companies, that could compromise the free exercise of their judgement*”.<sup>4</sup> Consequently, it is now possible, but not recommended, for a director to be classified as independent even if he has been an executive member of the board within the past three years.

In Germany there are more precise criteria by which to judge independence. The Corporate Governance Rules for German Quoted Companies define independent directors as those who are personally independent from management

and executive directors and who cannot be personally effected by the welfare of the company. They go on to stipulate that proposals for electing members to the supervisory board shall not include as a matter of course the election of retiring management board members.

In Switzerland, the draft for a Swiss Code of Best Practice (the Swiss Code) defines independent directors as non-executive board members who have either never been management members, or were so more than three years ago, and who have either no or a relatively minor business relationship with the company.

We asked chairmen participating in our European survey about which criteria they use to determine whether a director is independent. The responses are summarised below.

#### Independence criteria

	France	United Kingdom	Germany	Switzerland	Netherlands	Belgium	Total
Must not have been a member of senior management for more than five years	56%	25%	27%	38%	38%	36%	38%
Must not have been an employee of the company for more than five years	59%	64%	18%	32%	53%	36%	44%
Must not represent a significant shareholder or have a particular financial interest in the group (eg, a supplier)	83%	96%	45%	40%	69%	82%	66%
Must not receive any income from the company other than director's fees	88%	71%	59%	65%	94%	82%	77%
Must not benefit from any share option plan nor receive remuneration based on company performance	73%	93%	32%	17%	81%	55%	54%
Must have no conflict of interest with the company's management team	76%	89%	82%	95%	94%	86%	87%
Must have no financial or personal ties with the company or its management that could compromise their objectivity	83%	96%	86%	77%	94%	100%	87%

<sup>4</sup> Recommendations of the committee on Corporate Governance chaired by Mr Marc Viénot.

Opinions on independence differ considerably according to the countries surveyed. Responses from France and the United Kingdom were generally similar, with the exception of the first criterion (not having been a member of senior management in the past five years). For German respondents, the most important criteria are relatively close to those for Switzerland.

Overall, it appears that income other than director's fees received from the company, conflicts of interest with management, and the presence of financial or personal ties to the company and its management are considered decisive factors in determining independence.

Significantly, a higher proportion of United Kingdom respondents feel representation of single interest groups and participation in share option or performance-related remuneration schemes threaten independence. This may reflect the proliferation of employee representatives in countries such as Germany coupled with the fact that share option schemes are not as prevalent in many other countries and therefore the arguments surrounding their impact on independence are less rehearsed.

Few respondents from Germany (18%), Switzerland (32%), and Belgium (36%) considered directors not to be independent where they had been employees for more than five years. Again, for Germany this may reflect the proliferation of employee representatives on German boards, nevertheless the response from Belgium and Switzerland is less easy to explain. By contrast, only 25% of United Kingdom respondents considered directors to lose their independent status when they had served as a director for more than five years, while in (say) France, this test was supported by 56% of respondents.

It is perhaps worth noting that whilst independence is an admirable characteristic, independence alone is not necessarily the best measure of effectiveness to apply to a director. A director who has been an executive on the board on which they later serve as a non-executive may bring a wealth of insight and informed opinion (not to mention

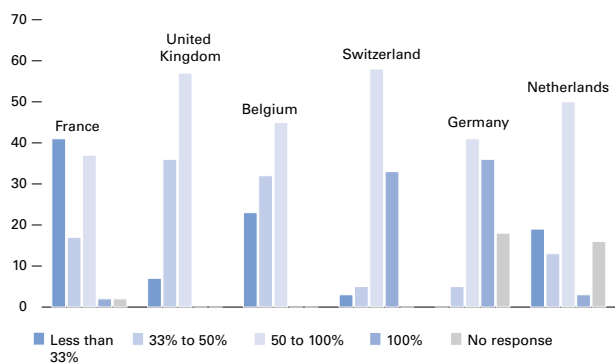
continuity) to the board which might be just as useful as the alternative perspective brought by those directors that are independent in the traditional sense.

### Board composition

It is important that boards maintain an independent element and most corporate governance codes provide some guidance as to what proportion of the board should be independent - in the United Kingdom, the recommendation is that non-executive directors should comprise not less than one third of the board, and that the majority of non-executives should be independent. Similarly, in France, *Viénot II* recommends that independent directors should account for at least one third of the board. Finally, the draft Swiss Code states that board members who do not perform any management function within the company should generally be in the majority.

Turning to two-tier boards, in the Netherlands the Peter's report recommends that supervisory boards should be such that the members are able to operate independently of one another and of the management board and in a critical way. Furthermore, no more than one former member of the management board should serve on the supervisory board. In Germany, the Corporate Governance Rules for German Quoted Companies propose that supervisory boards should comprise a sufficient number of independent persons.

Percentage of independent directors on the board



The extent to which the various guidelines and recommendations have been adopted can be observed above.

Practices clearly differ significantly, but are explained in part by cultural and legal differences.

Where two-tier boards operate (Germany and the Netherlands), management is entrusted exclusively to the management board, while the supervisory board fulfils an oversight function. Only the responses in relation to the supervisory board are presented above. As expected, German supervisory boards are predominantly comprised of independent directors. By contrast, it is curious that many respondents from the Netherlands have supervisory boards with relatively few independent directors and therefore deviate from the Peters report recommendations.

Non-executive directors comprised more than one third of the board in all the United Kingdom companies surveyed, and in all but 7% of companies the majority of non-executive directors were considered by the board to be independent. This demonstrated a high level of conformity with the Combined Code recommendations.

In line with the draft Swiss code of best practice, around 90% of Swiss boards comprise a majority of independent directors. The reasons for such a high rate of independence is not clear, but may well have something to do with the large shareholdings held by institutional investors. Alternatively, it could also be interpreted as the result of companies seeking listings on overseas capital markets, for example the NASDAQ.

By comparison with the United Kingdom and Switzerland, independent directors are poorly represented on Belgium boards. However, we believe that the number of independent directors on Belgium boards is increasing and this may well impact audit committees in future years.

France shows a marked split among its companies. On 41% of French boards, less than one-third of directors are independent, whereas 37% have a majority of independent directors. This dichotomy may arise because a significant number of French listed companies are still family-owned or

otherwise closely controlled. These companies tend to have few independent directors. Conversely, companies whose shares are publicly held, and especially those with institutional shareholders, have gone beyond the recommendations of the Viénot Report, and have many independent directors.

### 3.4 Stakeholder representation

We asked if board directors represented specific stakeholder categories (eg, employees, customers, or majority shareholders).

In France, 51% of respondents are owned by majority shareholders, who hold the majority of seats on 28% of their boards. Employees are represented on only 23% of the boards. Company by-laws may provide for the election of employees as directors, with all employees having the right to vote. The number of such directors is nevertheless limited to five for public companies limited by shares, and may not exceed one-third the number of the other directors.

In the United Kingdom, directors do not generally represent specific stakeholder groups. Directors' duties are owed to the company, not directly to its shareholders, albeit directors must have regard for the interests of present and potential shareholders, and also the company's employees, creditors and other stakeholders. Of the United Kingdom respondents, two companies indicated that they have directors who represent major shareholders. Nevertheless, as a matter of law, even the duties of these directors are owed to the company itself.

In Belgium, major shareholders are often represented on the board, however, customers, suppliers and government bodies are rarely represented. This is due, in part, to the large family shareholdings in some leading companies. Such companies are arguably slower to acknowledge the benefits of a more radical profile for board members, or to consider people from different backgrounds.

As a result of the structural regime, few Dutch boards include directors who represent specific stakeholder groups.

Nevertheless, a small number of respondents had boards that included representatives of major shareholders. An even smaller number of companies had employee representatives on their supervisory boards.

In Germany, suppliers and the government are very seldom represented on the Boards. However, a significant number of non-executive directors represent majority shareholders and still more represent employees. It is a peculiarity of German law that employees elect up to a half of supervisory board members.

### 3.5 Experience

In unitary boards, both executive and non-executive directors have overall responsibility for leadership and control. In order to fulfil this duty effectively, directors should have varied and complementary skills. For example, it may be advantageous for a high technology businesses to have some directors with specific scientific or technical skills. Furthermore, all boards are responsible for their companies' increasingly complex financial statements and therefore solid financial and accounting skills should be prevalent on all boards.

We asked, "How many directors have had more than two years work experience in the following areas?" We distinguished between executive directors and non-executive directors.

Most executive directors have more than two years experience in finance. Marketing and operational expertise is also prevalent on most boards. Interestingly, Belgium and French boards do not appear to have the breadth of experience as many of their European counterparts. The reason for this is unclear, however, for as long as board members continue to be drawn from a small pool, there will be questions, both about the breadth of expertise and experience on many French and Belgium boards, and their ability to innovate.

Germany, Switzerland, the Netherlands and the United Kingdom all reflect similar trends. The one exception is technology/research and development where United Kingdom boards appear to be poorly represented.

Executive directors

	Finance	Marketing Sales	Production/ Operations	Technology/ R&D	Other
France	63%	44%	34%	22%	7%
United Kingdom	93%	71%	68%	25%	29%
Germany	95%	82%	73%	59%	9%
Switzerland	83%	75%	65%	55%	17%
Netherlands	88%	94%	69%	59%	22%
Belgium	64%	59%	59%	45%	9%
Total	79%	69%	59%	43%	15%

The national trends for non-executive directors are similar to those for executive directors, though curiously French boards have a relatively large number of non-executive directors with financial experience whilst German Boards have relatively few financial experts amongst their non-executive directors.

For Switzerland, Belgium and the Netherlands, non-executive directors are, on the whole, more experienced in the stated areas than their executive colleagues. By contrast, in Germany, France and the United Kingdom, non-executive directors are generally less experienced than their executive colleagues.

In order to sustain shareholder confidence, companies would be well advised to disclose the skills and backgrounds of their directors, in order to demonstrate the contribution each director can make. Some corporate governance codes include similar recommendations, for example, in the United Kingdom the Combined Code recommends that the names of directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholders to take an informed decision on their election. While there is no guidance as to what is, and what is not sufficient, it would be reasonable to discuss the specific contribution of each director and, where appropriate, factors enabling the director's independence to be determined.

We recommend that this information be included in annual reports.

### 3.6 Board size

The number of directors constituting a board is an important factor in determining board effectiveness. A board must be of sufficient size to benefit from a diversity of viewpoints, skills and backgrounds, yet be manageable by the chairman. If a board is too large, directors may not be able to fully participate in discussions and decision-making may be hindered.

Corporate governance codes do not cover board size in the United Kingdom, Switzerland or the Netherlands. United Kingdom law, however, does require that public companies registered on or after 11 November 1929 have at least two directors. Companies registered before that date may have only one director. The draft Swiss Code recommends that the number of board members should be geared to the requirements of the business and should be as small as possible.

In Germany, a supervisory board must have between 3 and 21 members depending on the size of the company's share capital whereas a management board must comprise at least one member but can have several members. According to the

Non-executive directors

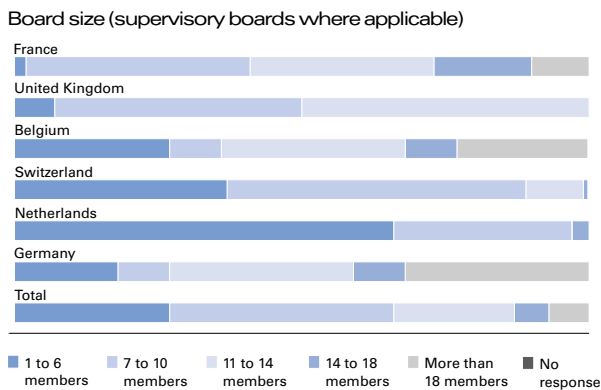
	Finance	Marketing Sales	Production/ Operations	Technology/ R&D	Other
France	73%	22%	24%	17%	10%
United Kingdom	89%	61%	64%	39%	68%
Germany	68%	50%	50%	41%	14%
Switzerland	88%	82%	68%	65%	32%
Netherlands	94%	88%	72%	59%	47%
Belgium	77%	59%	64%	36%	18%
Total	83%	67%	63%	50%	34%

recommendations of the German Code on Corporate Governance, the management board should be limited to nine members and the supervisory board should, if permissible, have six or nine members but never exceed the minimum size stipulated by statute.

In France, the New Economic Regulations (2001) now limit the number of directors to 18. Before the reforms, the limit was 24. The AFG-ASFFI recommends no more than 16 directors.

In Belgium, the Banking and Finance Commission recommends that boards should not exceed 12 members.

We examined the size of unitary boards and supervisory boards. Our findings are summarised below.



It is apparent that in those countries operating unitary boards, board size is more varied in France and Belgium than in Switzerland and the United Kingdom. Furthermore, United Kingdom boards are, in general, smaller than those in France and Belgium. But, on average, Switzerland has the smallest unitary boards.

Of those countries operating two-tier boards structures, supervisory boards in the Netherlands are, in general, significantly smaller and much less varied in size than those in Germany. It is worth noting that the average size of management boards in the Netherlands is three members which is approximately half the size of supervisory boards.

Opinions on the advantages of large or small boards are clearly divided. Many of those who favour large boards do so on the basis that they allow considerable scope for the representation of diverse interests. However, those advocating small boards believe issues can be debated more easily among a smaller number of people and therefore strategic issues can be more convincingly resolved.

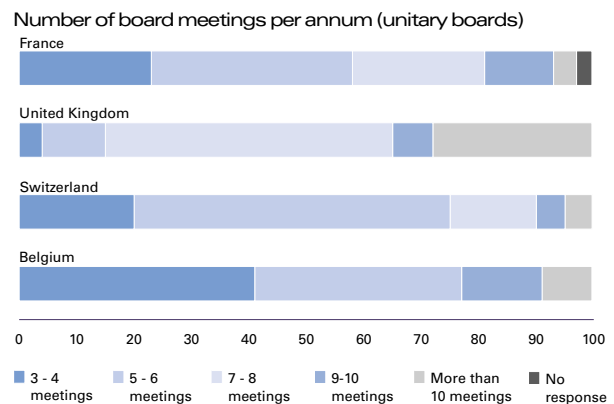
### 3.7 Frequency of board meetings

We asked companies how often their boards met. Companies with two-tier boards were distinguished from those with unitary boards.

#### Unitary boards

Corporate governance codes in Belgium and the United Kingdom recommend that boards should meet regularly, but do not recommend a specific number of meetings. Similarly, there are no recommendations addressing the duration of board meetings. There are no Swiss recommendations covering the frequency or duration of board meetings but in France, Viénot recommends three to four roughly two hour meetings per annum.

United Kingdom boards appear to meet more frequently than their European counterparts, with 86% of those responding to the survey having in excess of seven board meetings in the last financial year, while a significant 29%



had more than ten meetings. By contrast, 77% of Belgium respondents and 75% of Swiss respondents had less than seven board meetings in the last financial year.

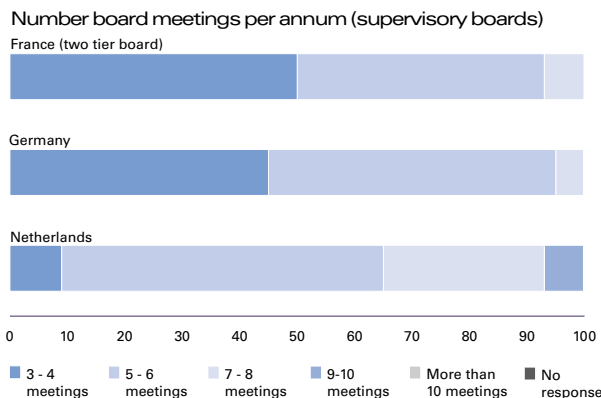
### Two-tier boards

In Germany, the KonTraG requires publicly traded companies to meet at least four times per year. Before the 1998 legislative reforms, the minimum number of meetings was two.

French law is silent as to the frequency of board meetings. Nevertheless, where the two-tier approach is adopted the law requires that the management board present a report to the supervisory board at least once every quarter. In essence therefore, supervisory boards must meet at least quarterly.

In the Netherlands, the Peters report recommends that supervisory boards meet according to a predetermined time schedule but does not specify the frequency board meetings.

The similarity between France and Germany is striking. Around 50% of boards meet only four times per annum (effectively the legal minimum), whilst most others meet between five and six times per annum. By contrast, in the Netherlands where there are no rules or recommendations in this area, the vast majority of boards meet more than four times per annum.

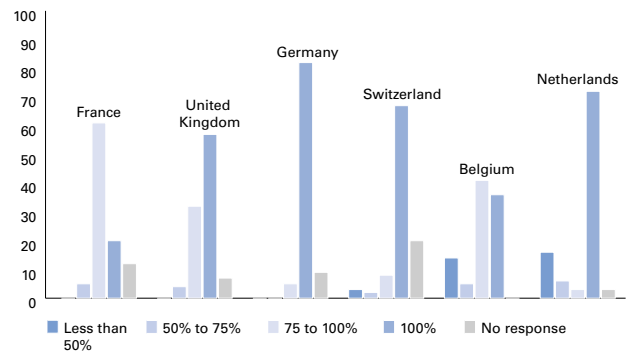


In Germany, management boards meet an average of 32 times per annum while in the Netherlands the average is around 25 meetings per annum.

### 3.8 Attendance at board meetings

Wherever possible directors should participate in board meetings. Absence does not exonerate a director from liability.

Directors attendance rate at board meetings



Swiss boards appear to be marginally better attended than their United Kingdom counterparts which is perhaps expected as United Kingdom boards meet much more frequently. Paradoxically, French boards (which are predominately unitary in nature) are surprisingly poorly attended even though they meet relatively infrequently. This may in part be explained by the fact that a large number of French directors serve on multiple boards though this phenomenon is not entirely unique to France. It should be noted that both the Viénot II and AFG recommendations suggest that annual reports include disclosure of the number of board meetings during the year and the attendance record.

Turning to two-tier boards, the attendance rate is very high in Germany, where 82% of supervisory board meetings are attended by all members. Such high attendance rates may in part be explained by the fact that there are relatively few

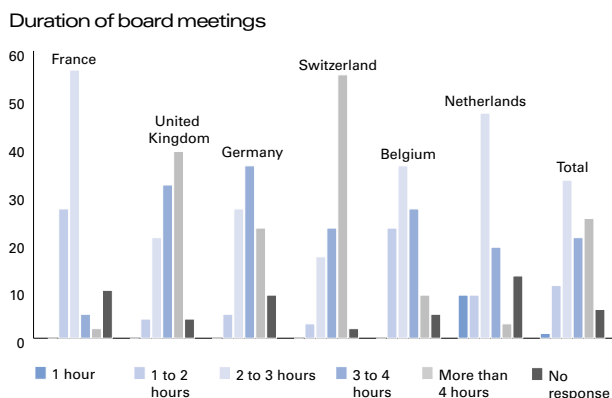
supervisory board meetings in Germany. Also, it should be noted that attendance is encouraged by the Corporate Governance Rules for German Quoted Companies which recommend that annual reports include details of members who have participated in fewer than half of the supervisory board meetings.

Dutch companies also operate a two-tier board system, but attendance at supervisory board meetings is not as high as that in Germany. Perhaps this is to be expected as supervisory boards meet more frequently in the Netherlands. Reminiscent of the Corporate Governance Rules for German Quoted Companies, the Peters report recommends that individual members of the supervisory board should be called to account for frequent non-attendance.

### 3.9 Duration of board meetings

The average duration of board meetings (supervisory board meetings where applicable) by country is shown below.

It can be seen that board meetings in the United Kingdom and Switzerland are generally longer than board meetings elsewhere. For supervisory boards, the duration of meetings in Germany tends to be longer than those in the Netherlands.



<sup>5</sup> NACD, Report of the NACD Blue Ribbon Commission on Director Professionalism, Washington 1996.

### 3.10 Evaluating boards, audit committees and chairmen

Effective boards, audit committees and chairmen will be conscious of their own culture, their strengths and weaknesses and the possibilities for constructive change. It is beneficial for boards and individual directors to be open to continuous learning through a self assessment or similar processes.

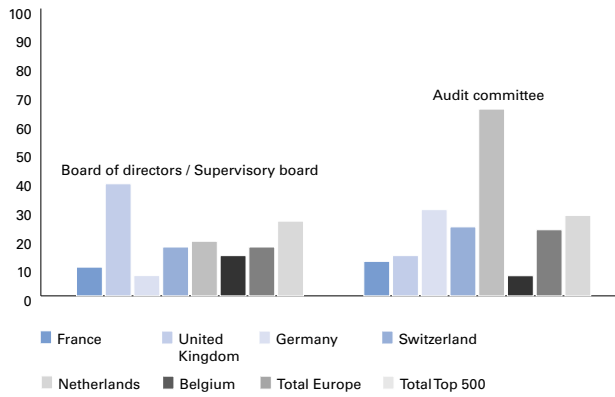
In the USA, the National Association of Corporate Directors’ Blue Ribbon Commission on Director Professionalism (NACD commission) endorsed the concept of self-assessment, including the assessment of individual director’s contributions to board performance. The Commission argued that *“by participating in their own assessment, directors can ‘own’ a process that should belong to them, since the board is responsible for its own performance. Moreover, because directors themselves control the process by which they are recommended to shareholders for election, self-evaluation by the board and by directors can send a strong signal of accountability to shareholders, while providing assurance to directors themselves that their good work will not go unnoticed.”*<sup>5</sup>

In Europe we have witnessed instances of shareholders encouraging boards to implement processes for reviewing the performance of individual directors, audit committees and boards. It is important that companies establish an appropriate competency framework and process to use for evaluation purposes.

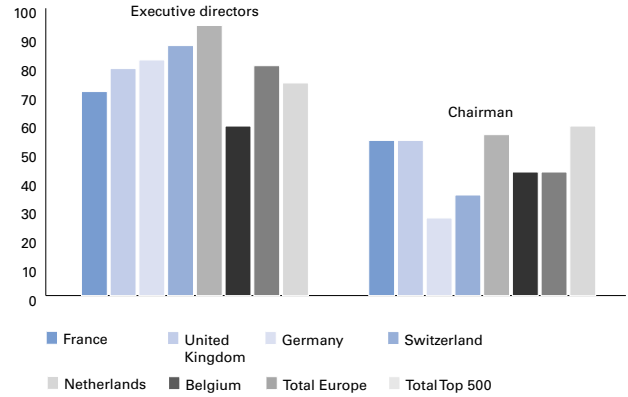
We asked whether procedures had been established for the regular evaluation of boards and audit committees.

Overall, only 17% of respondents had established procedures for the regular evaluation of their boards and only 26% of respondents regularly evaluated their audit committees. Interestingly, when one looks only at those companies falling within the top 500 European companies, the percentage of respondents regularly evaluating boards and audit committees rises to 26% and 28% respectively.

Evaluation of boards and audit committees



Evaluation of executive directors and chairman



The findings varied widely from country to country. Evaluation of board performance appears to be more prevalent in the United Kingdom with 39% of respondents having a regular process for the evaluation the board. Curiously, when it comes to audit committees, the position is reversed even though such committees are more established in the United Kingdom. Only 14% of United Kingdom respondents have a process for the regular evaluation of the audit committee which compares unfavourably with Germany (30%) and the Netherlands (65%).

In Belgium, only 14% of the respondents evaluated their full board and 5% evaluated their audit committees. This may be because few Belgium companies formally set out their boards' responsibilities.

German and Dutch companies distinguish between the evaluation processes for supervisory and management boards. While 36% of German respondents have a process for the regular evaluation of the management board only 9% of respondents have a similar process for the evaluation of the supervisory board. Evaluation of the supervisory board is more prevalent in the Netherlands (19%).

We also asked whether the performance of the chairman and executive directors was evaluated by the non-executive directors. The response was as follows.

The percentage of respondents whose non-executive directors evaluated the performance of the executive directors varied from 94% in the Netherlands to 59% in Belgium. The European average was 80%. Evaluation of the chairman's performance by the non-executive directors was less common.

## Specialised committees

4	Specialised committees	23
4.1	Audit committees	24
4.2	Remuneration or compensation committees	30
4.3	Nomination committees	32

## Specialised committees

The establishment of sub-committees is often desirable within the unitary board structure as boards cannot always deal thoroughly (or objectively) with every issue falling under their jurisdiction. The three sub-committees most often referred to in corporate governance codes and recommendations are the audit committee, the remuneration or compensation committee, and the nomination committee.

### 4.1 Audit committees

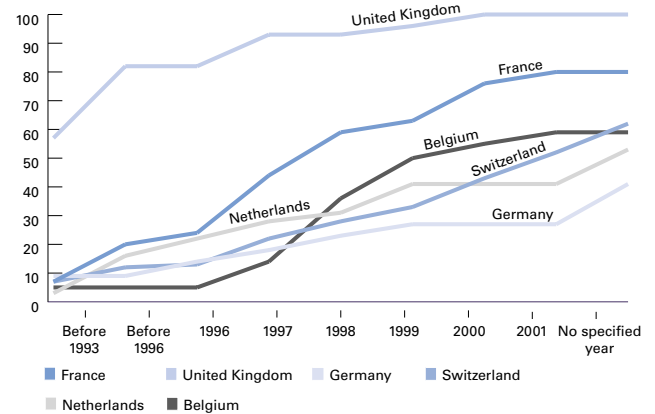
Audit committees are established to give additional assurance about the quality and reliability of financial information used by the board and the financial statements issued by the company. Where audit committees operate effectively, they have the potential to:

- improve the quality of financial reporting;
- create a climate of discipline and control which will reduce the opportunity for fraud;
- enable the non-executive directors to contribute an independent judgement and play a positive role in controlling the business operations;
- help the finance director by providing a forum in which he can raise issues of concern;
- strengthen the position of the external auditor by providing a channel of communication and forum for raising issues of concern;
- provide a framework within which the external auditor can assert his independence in the event of a dispute with management;
- strengthen the position of the internal audit function by providing a greater degree of independence from management; and
- increase public confidence in the credibility and objectivity of financial statements.

### Existence of audit committees

In the United Kingdom, the Cadbury report recommended that boards of listed companies set up audit committees as long ago as 1992. It is therefore unsurprising that the survey shows that audit committees are more established in the United Kingdom than in the rest of Europe.

Percentage of companies with an audit committee (cumulative)



Overall, 67% of respondents had established audit committees. Audit committees were found to be most widespread in the United Kingdom where all respondents reported the existence of such a committee. The extensive use of audit committees was also reported in France (80%), Belgium (59%) and Switzerland (62%). Perhaps as a result of the two-tier board structure, only 41% of German respondents and 53% of Dutch respondents had established audit committees.

In the United Kingdom, only 18% of audit committees had been established later than 1995. Interestingly, 57% of respondents had established their committees prior to 1992, and thus before the Cadbury recommendations. The rest of Europe did not reach this level until 2000. This may reflect the power of institutional investors in the United Kingdom, or the similar nature of the United Kingdom and US

governance models. (Note, since 1978, the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors.)

The growth in popularity of audit committees elsewhere in Europe is generally uniform. However, the number of French companies with audit committees can be seen to rise sharply following the initial impact of the Viénot report. Similarly, in Belgium, the number of companies having audit committees can be seen to rise sharply following the recommendations of the Federation of Belgium Companies and the Cardon Commission report.

It is noticeable that in Germany and the Netherlands, the two countries operating two-tier boards, the popularity of audit committees lags behind other European countries. It has been suggested that this is probably because the implementation of independent and objective board committees is regarded as less important where supervisory boards exist.

### Audit committee responsibilities

In France, the Viénot committee report lists the principal responsibilities of the audit committee:

- Business analysis.
- Overseeing the audit of the financial statements.
- Ensuring that accounting methods are consistently applied.
- Verifying the statutory auditors' independence and objectivity.
- Validating the work carried out by the financial department and statutory auditors, particularly the accounting methods chosen to consolidate the accounts.

The Combined Code also addresses the duties of the audit committee which, in its view, should include keeping under review the scope and results of the audit and its cost

effectiveness and the independence and objectivity of the auditors. Also, where the auditors supply a substantial volume of non-audit services to the company, the Combined Code recommends that the audit committee keep the nature and extent of such services under review and seek to balance the maintenance of objectivity and value for money.

We asked whether audit committees had formal written charters setting their responsibilities. In the United Kingdom, all respondents had established a charter describing the audit committee responsibilities. By contrast, in Switzerland and France, 68% and 58% of respondents respectively had an audit committee charter, while in Germany the proportion having an audit committee charter was even less (40%).

We also asked whether the audit committee's remit included the following.

#### Audit committee remit

	France	United Kingdom	Germany	Switzerland	Netherlands	Belgium
The adequacy of the system of internal control and risk management	88%	96%	70%	92%	100%	91%
The quality of the accounting policies, judgements and disclosures	94%	100%	80%	97%	100%	91%
Consideration of the independence and objectivity of external auditors	67%	93%	90%	81%	88%	75%
Consideration of the proposed scope of the external auditors work	61%	93%	80%	70%	88%	75%
The process for monitoring compliance with relevant laws and regulations	48%	79%	70%	92%	59%	82%
Consideration of the scope, authority, and resources of internal audit	45%	86%	60%	84%	71%	67%
Consideration of the need for internal audit where no such function exists	24%	14%	20%	57%	59%	42%
Reviewing the work of internal audit and verify that their recommendations are implemented	52%	82%	30%	81%	71%	73%
The interim financial statements and the process used to prepare them	79%	93%	40%	73%	82%	83%
The preliminary announcement and financial reporting package	76%	100%	90%	73%	88%	77%
Non-financial information included in the annual report, or otherwise made public	30%	71%	40%	54%	35%	15%

Clearly most European audit committees are responsible for overseeing the scope and results of the audit and the independence and objectivity of the auditors. However, audit committees in Belgium and France appear less likely to oversee both internal and external audit than their counterparts.

Across Europe, most audit committees review of the preliminary announcement, financial reporting package and interim statement. The exception is Germany where few audit committees (40%) review the interim financial statements. The reasons for this are not clear.

Interestingly, a significant number of United Kingdom respondents had audit committees whose remit included the examination of non-financial information included in the annual report or otherwise released to the public. This may well reflect the importance attached to these areas in recent initiatives such as the Turnbull report and the proposals for the reform of company law. Alternatively, it may suggest a higher take up of initiatives such as ISO 14001 (Standard for environmental management systems) and EMAS (Eco Management and Audit Scheme) than elsewhere.

### Audit committee composition

Most corporate governance codes include some recommendations concerning the composition of audit committees. In the United Kingdom, the Combined Code recommends that the audit committees should comprise at least three directors all of which should be non-executives and the majority independent. Similarly, the Brussels Stock Exchange recommends that audit committees should comprise at least three non-executive directors whose authority and duties are clearly stated at the time of their appointment.

In France, the Viénot Committee recommended that at least one third of audit committee members be independent (ie, must neither be employees nor part of the senior management of a company). The AFG report, which is less influential than the Viénot report, recommended that the audit committee should comprise at least three non-executive directors, one of which must be independent.

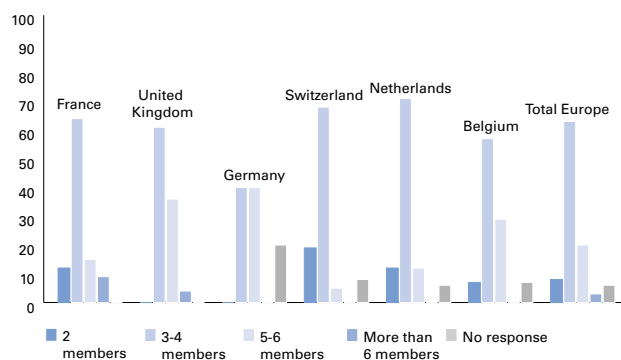
The draft Swiss Code recommends that the audit committee be comprised of non-executive, and preferably independent, members. Furthermore, a majority, including the chairman, should have experience of finance and accountancy.

By contrast, the recommendations in Germany and the Netherlands are less specific. The Peters report (Netherlands) recommended that audit committees be comprised of supervisory board members, whilst the German Code of Corporate Governance recommends that audit committees should have at least three, but no more than five members. The rules governing how audit committees are established in Germany are embodied in the Companies Act, but the implementation itself is not mandatory.

### Audit committee size

Across Europe, the most frequently encountered audit committees comprise between three and four members. Only in Germany are larger audit committees equally as popular.

Audit committee size

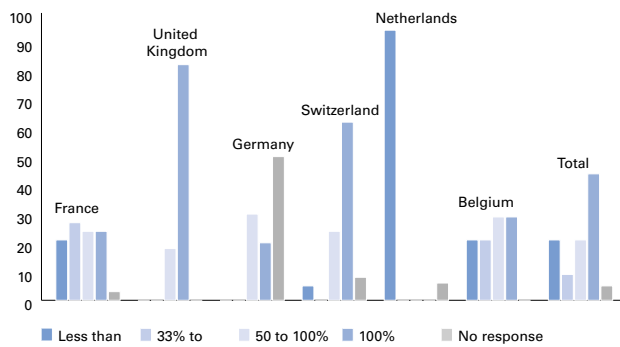


We investigated whether audit committee size was linked to board size. In France, Switzerland and the United Kingdom, audit committees were approximately a third of the size of the board. Turning to two-tier boards, audit committees were 29% as large as supervisory boards in Germany, but around 60% the size of supervisory boards in the Netherlands.

### Audit committee independence

The audit committee is responsible for overseeing the financial reporting process and increasingly often, the effectiveness of the system of internal control and risk management. In carrying out its duties, the audit committee may need to challenge the judgement of management or take positions that may be contrary to those of the executive directors. Because of this supervisory or oversight role, independence is an essential quality for audit committee members.

Independent director representation on audit committees



All United Kingdom respondents had audit committees comprised solely of non-executive directors, and in each case the majority of members were, as the Combined Code recommends, considered independent. (82% of audit committees comprised exclusively independent non-executive directors while 18% of audit committees had a majority of independent members.) In Switzerland, which has as yet no code in this area, 62% of audit committees consist exclusively of independent directors. In Belgium, even fewer audit committees were wholly independent,

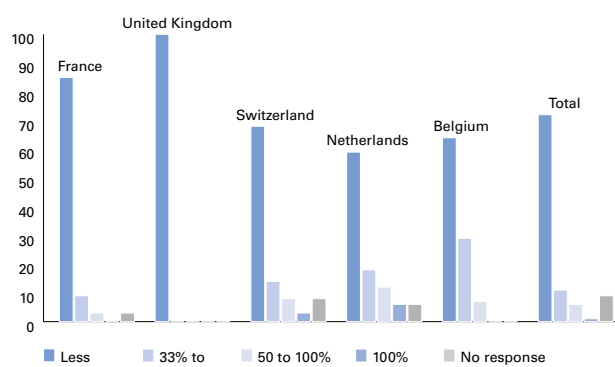
Even though the Viénot Committee recommended that at least one third of audit committee members be independent, the results from France were mixed. Some progress has been made with 24% of audit committees consisting entirely of independents. However, there are still many committees (21% of respondents) where the independent representation amounts to less than one third of the members.

As audit committees are sub-committees of the supervisory board in two-tier board regimes, one would expect that they would consist exclusively of independent directors. However, this is not the case. In fact, relatively few audit committees are predominantly independent. We believe this peculiarity arises because chief executive officers, finance directors and internal auditors often attend audit committee meetings and have therefore been reported as members. Intriguingly, in Germany there was a high rate of non-response to the question (50%).

Executive directors on audit committees

Overall, 72% of respondents had audit committees where less than one third of the members were executive directors. Further analysis revealed that 49% of committees did not have a single executive member.

Executive directors on audit committees



No United Kingdom respondents had audit committees with members who were executive directors. France and Switzerland lean towards the United Kingdom model though in Switzerland, which as yet has no code in this area, executive directors account for more than one third of audit committee members in 25% of those companies responding (France 12%).

Executive directors are also heavily represented on Belgium audit committees with around 36% of audit committees including more than one third executive members.

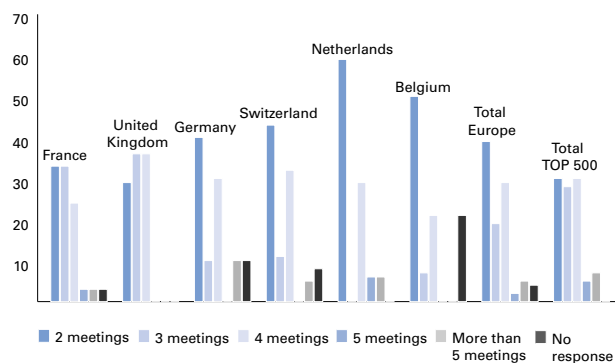
The fact that so few Dutch and German audit committee members are independent continues to be an issue. Again, as audit committees are sub-committees of the supervisory board, one would not expect executive members, however, in practice it appears that while executive directors are not generally members of supervisory boards, they are heavily represented on audit committees.

### Frequency of audit committee meetings

The frequency of audit committee meetings is determined by a number of factors, for example:

- the committees remit;
- the duration of committee meetings; and
- whether the company is reporting quarterly or half yearly.

Number of audit committee meetings per annum

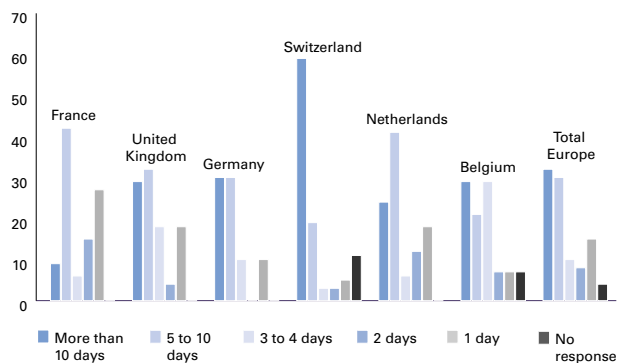


Across Europe, 39% of audit committees meet twice a year (which corresponds to their half yearly and end-of-year financial statements), while a significant 29% meet four times per annum (corresponding to a quarterly reporting timetable). In the United Kingdom, 72% of audit committees meet more frequently than twice a year, with 36% meeting quarterly. This may reflect the influence of institutional investors and their demands for information or perhaps the significant role many audit committees play in regularly reviewing management reports on internal control.

### Timing the final audit committee meeting

In each country surveyed, around two-thirds of companies left five days or more between the final audit committee meeting and accounts closure. Switzerland is exceptional in that 59% of companies had their final audit committee meeting more than ten days before the accounts were finalised. The reasons for this are unclear.

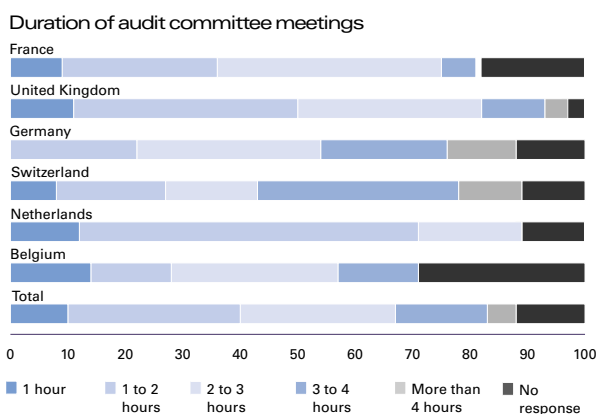
Time between audit committee meeting and accounts approval



It is interesting to note that 27% of French respondents and 18% of Dutch and United Kingdom respondents had their final audit committee meeting only one day before the results are finalised. Whether this suggests that the audit committee's review is merely a formality, or alternatively that the committee's ongoing monitoring role negates the need for late adjustments, is open to question.

### Duration of audit committee meetings

There appears to be little correlation between the duration of audit committee meetings and the frequency in which meetings are held.



French audit committee practices are beginning to resemble those in the United Kingdom with roughly one-third of audit committee meetings lasting between one and two hours, and one-third lasting between two and three hours.

By cross-analysing the data, it becomes clear that in the United Kingdom, audit committees are well established and fulfil an essential control function. By contrast, in Germany audit committees are less well established and their role is still rather limited.

## 4.2 Remuneration or compensation committees

Directors' remuneration has been, and will continue to be, a sensitive subject. One only has to review the financial press to see that shareholders are, more than ever before, willing to question remuneration packages which they do not consider to be in the best interests of their company.

Shareholders are entitled to expect directors' remuneration to be sufficient to attract, retain and motivate executive

directors of the quality required but not more than is necessary for that purpose. For this reason the interests of directors and shareholders should be aligned and directors' remuneration should generally be linked to directors' performance and efforts, rather than general market fluctuations. In principle, remuneration should reflect the relative performance within a comparator group regardless of market conditions although there is also a place for arrangements that enable directors to share in a company's general economic success.

In order to establish rigorous and transparent procedures for developing executive remuneration policy and for fixing the remuneration packages of individual directors, many corporate governance codes recommend that remuneration committees be established.

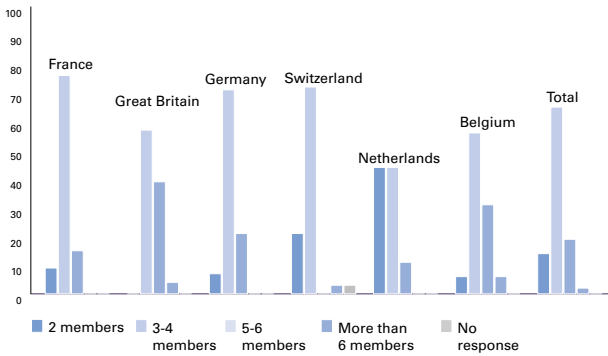
Remuneration committees were found to be most widespread in the United Kingdom where all respondents reported the existence of such a committee. The extensive use of remuneration committees was also reported in France (80%) and Belgium (73%). Only 48% of Swiss respondents reported the existence of a remuneration committee - this is perhaps due to there being no established corporate governance codes that cover this issue in Switzerland to date.

Perhaps as a result of the two-tier board structure, only 64% of German respondents and 56% of Dutch respondents had established remuneration committees.

### Remuneration committee size and independence

In the United Kingdom, the Combined Code recommends that to avoid potential conflicts of interest, boards should set up remuneration committees of independent non-executive directors to make recommendations to the board, within agreed terms of reference, on the company's framework of executive remuneration and its cost; and to determine on their behalf specific remuneration packages for each of the executive directors, including pension rights and any compensation payments.

Remuneration committee size

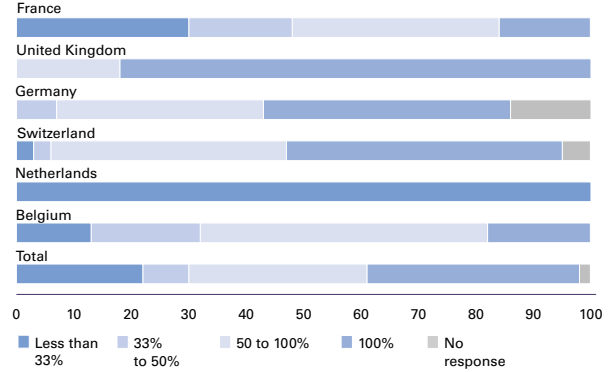


The Combined Code goes on to recommend that remuneration committees should consist exclusively of non-executive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Similarly, in Belgium, remuneration committee are considered good practice and should comprise only non-executive directors. Where no remuneration committee is established, the non-executive directors should decide on the principles of executive remuneration.

In France, Viénot recommended that remuneration (or compensation) committees should have a majority of independent directors among their members. (Note, for audit committees Viénot recommended that independent directors comprise 33%.) The AFG proposed that remuneration committees comprise at least three non-executive directors, one of which must be independent. The draft Swiss Code also recommends that a majority of the remuneration committee should consist of independent non-executive directors.

In the Netherlands all remuneration committee members are supervisory board members and therefore, independent from management. Clearly, respondents did not believe this to be the case. We believe this is because executive directors and others often attend remuneration committee meetings and have therefore been reported as members.

Independent directors represented on remuneration committees



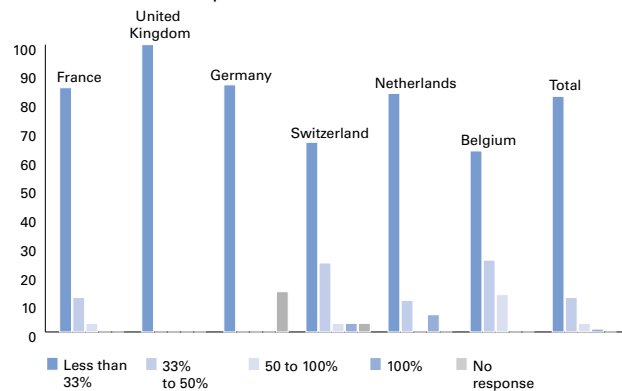
With the exception of France and the Netherlands, respondents from most countries had remuneration committees comprising a majority of independent directors. It is not clear why so many French respondents had not followed Viénot’s recommendations nor why Dutch respondents had remuneration committees that contained so few independent directors.

All but five United Kingdom respondents had remuneration committees that were wholly comprised of independent non-executive directors.

### Executive directors on remuneration committees

Significant executive representation on remuneration committees is rare. Nevertheless, executives often attend committee meetings.

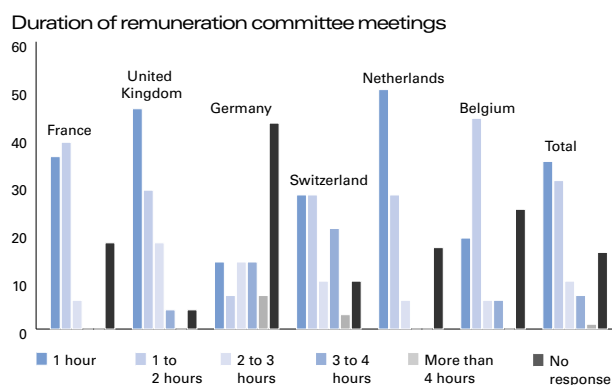
Executive directors represented on remuneration committees



Only two United Kingdom respondents included any executive directors on their remuneration committees. By contrast, the prevalence of executive directors on remuneration committees is far greater in Belgium and Switzerland where the recommendations are not so tightly drawn.

#### Duration of remuneration committee meetings

We asked companies about the average duration of their remuneration committee meetings.



Across Europe the duration of remuneration committee meetings was generally two hours or less. There is some evidence to suggest that remuneration committees meet more frequently in Germany and the United Kingdom than elsewhere in Europe. Only 14% of German respondents and just over a third of United Kingdom respondents had remuneration committees which meet less than three times per annum while in Switzerland half of respondents' remuneration committees met less than three times, and in France, 67%.

### 4.3 Nomination committees

It is important that boards maintain an appropriate mixture of skills, experience and objectivity. One approach to making board appointments, which makes clear how appointments are made and assists boards in making them, is through nomination committees charged with the responsibility for proposing to the board, in the first instance, any new executive or non-executive directors.

As long ago as 1992, the Cadbury report recommended that companies establish nomination committees, but did not make this part of its Code of Best Practice. Nevertheless, in 1998, this recommendation was incorporated into the United Kingdom's Combined Code with the proviso that such committees may not be appropriate for small boards.

Nomination committees are also encouraged by corporate governance codes in Belgium, France, Germany, and the Netherlands. In Switzerland, it is likely that nomination committees will be encouraged for large public companies.

Our survey revealed that nomination committees are most widespread in the United Kingdom where 96% of respondents reported the existence of such a committee. Elsewhere, nomination committees were not used extensively, though 39% of French respondents, 32% of Belgium respondents and 22% of Swiss respondents reported the existence of such committees. Perhaps as a result of the two-tier board structure, only 16% of Dutch respondents and 9% of German respondents had established nomination committees.

#### Nomination committee size and independence

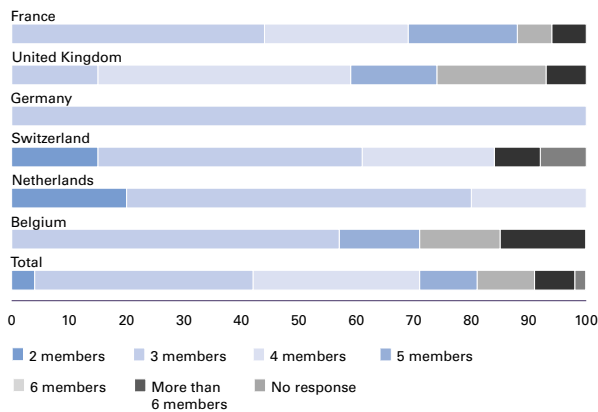
The Combined Code recommends that a majority of nomination committee members should be non-executive directors and that the chairman should either be the chairman of the board or a non-executive director. The Belgium recommendations are similar to those in the United Kingdom. Both codes are silent on the question of independence.

In France, the Viénot report goes further in recommending that independent directors should account for at least one third of the committee and that the chairman of the board should be a member of the committee, but not its chairman. More specifically, Viénot goes on to recommend that the nomination committee should draw up a plan for succession of the executive directors - including the chief executive officer.

In the Netherlands, the Peters report recommends that, like audit and remuneration committees, nomination committees should be comprised of supervisory board members.

Turning to the independence of nomination committee members, it can be seen from the chart below that the various corporate governance recommendations have been adopted in some countries, but not in others.

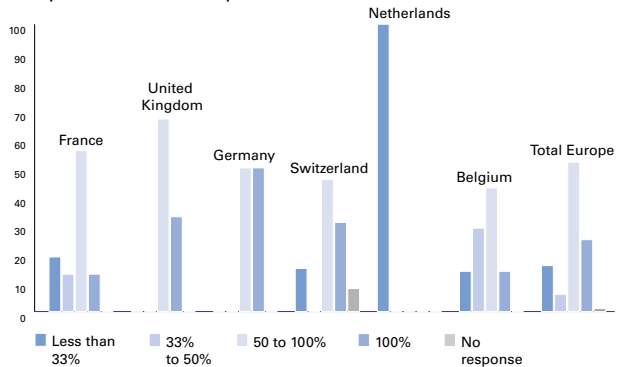
Nomination committee size



The average number of nomination committee members varies from country to country, however, most committees have between three and five members. Generally nominations committees were larger in the United Kingdom than elsewhere.

Only respondents from Switzerland and the Netherlands had nomination committees with two members. Conversely, in Germany, practices were uniform, with 100% of respondents having nomination committees comprising three members. To put this in perspective, out of the 60 nomination committees surveyed, only two were in Germany.

Independent director representation on nomination committees



France, Belgium, Switzerland and the Netherlands (see below) reported nomination committees with a minority of independent directors. It is distressing that nearly 20% of French respondents have nomination committees comprising less than one-third independent directors and therefore do not follow the Viénot recommendations. Switzerland has no established code in this area.

By contrast, respondents from the United Kingdom appear to have little difficulty in complying with the Combined Code recommendations - in each case a majority of committee members are non-executive directors, while a third of respondents had nomination committees comprised solely of non-executive directors.

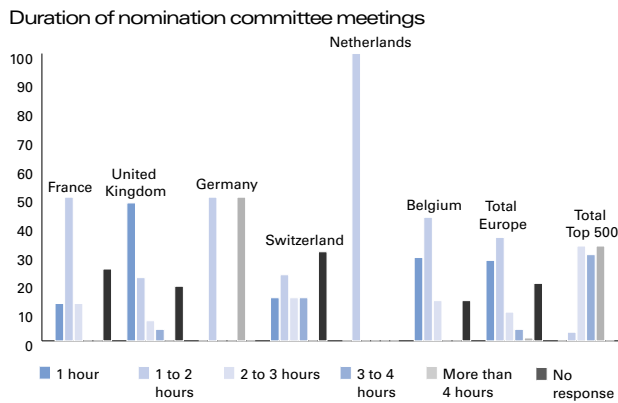
In Germany, 50% of respondents had nomination committees comprised exclusively of independent directors.

In the Netherlands, one would expect all nomination committee members to be supervisory board members and therefore independent from management. The reason why all Dutch respondents reported nomination committees with less than one third independent representation is unclear but

may be because executive directors and others often attend nomination committee meetings and have therefore been reported as members.

### Duration of nomination committee meetings

We asked companies about the average duration of their nomination committee meetings.



The difference between the results from across the whole sample and those from the European top 500 companies is startling. Over 60% of respondents from the European top 500 meet for at least four hours to consider nominations for directors and senior executives - for the sample as a whole, only 6% of respondents have nomination committee meetings that exceed 4 hours in duration. The reasons for this may be twofold. First, the top 500 companies have, on average, larger boards and therefore it would be reasonable to suppose that there are more nominations to examine. Secondly, companies with a diverse shareholder base may spend more time discussing the appointment of directors because such appointments are generally subject to a greater degree of scrutiny than those in companies that are closely held by a majority shareholder or family group.

# Internal control and risk management

5	Internal control and risk management	35
5.1	Responsibility for the system of internal control	36
5.2	Risk awareness	37
5.3	What is the system of internal control?	37
5.4	Risk identification and evaluation	39
5.5	Embedding the system of internal control and risk management	40
5.6	Reviewing the system of internal control and risk management	40
5.7	Does risk management add value?	41

## Internal control and risk management

Risks are inherent to business and their crystallisation may have a positive as well as a negative outcome. It is vital that those responsible for the stewardship and management of an organisation be aware of the best methods for identifying, and subsequently managing such risks. Of course, internal control is only one of the means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptably risky activities. Ultimately, risk can be accepted. Getting the balance right is the essence of successful business - to knowingly take risk, rather than be unwittingly exposed to it.

Most corporate governance codes have hitherto restricted the issue of internal control to internal financial control, but the latest United Kingdom guidance *Internal Control: Guidance for Directors on the Combined Code* (the Turnbull report) makes explicit the directors responsibilities in respect of all controls, including financial, operational and compliance controls and risk management.

Germany too have recognised the importance of a full control framework. The law on control and transparency in business (KonTraG), which came into force in May 1998 requires boards to ensure that adequate risk management systems are maintained.

Both the United Kingdom recommendations and the German regulations seek to enhance transparency through disclosure in the annual report and accounts.

### 5.1 Responsibility for the system of internal control

A key tenant of the Turnbull report is that board's are ultimately responsible for the system of internal control. Boards will normally delegate to management the task of establishing, operating and monitoring the system, but they cannot delegate their responsibility for it.

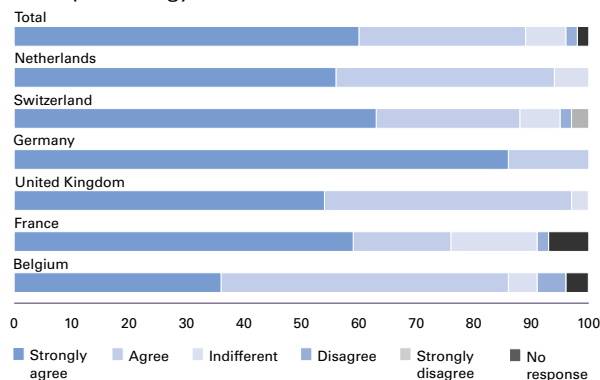
It is essential that the right tone is set at the top of the company - the board should send out a clear message that

control responsibilities must be taken seriously. The board should set appropriate policies on internal control and regularly assure itself that the processes for monitoring the risks to which the company is exposed are appropriate and that the system of internal control is effective in reducing those risks to an acceptable level.

However, the board does not have sole responsibility for a company's system of internal control - all employees have some accountability towards implementing the board's policies on risk and control. This reflects the 'top-down, bottom-up' nature of a sound system of internal control. The 'tone at the top' is set by the board, but it is the role of management to implement the policies adopted by the board, identify and evaluate the risks faced by the group and design, operate and monitor an appropriate system of internal control.

We asked chairmen whether the board (or supervisory board) had a clearly developed strategy.

Does the board / supervisory board have a clearly developed strategy?



Respondents generally considered that their boards had clearly developed strategies, though significantly, a minority of respondents from Belgium, France and Switzerland did not.

## 5.2 Risk awareness

The Turnbull report suggests that when determining what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:

- the nature and extent of the risks facing the company;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the likelihood of risks materialising;
- the company's ability to reduce the incidence and impact of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

We asked chairmen whether their boards (or supervisory boards) were fully aware of the significant risks, and the significant opportunities, faced by their companies.

Respondents generally agreed that their board was aware of the significant risks facing their company, and to a slightly less degree, the significant opportunities facing their company. One wonders whether this optimism will prove to be well founded if, as many economists suggest, Europe

enters a recession in the near future. United Kingdom respondents appear to be marginally more bullish than their colleagues as all respondents either agree or strongly agree with the proposition. This is probably due to the impact of the Turnbull report and its focus on the board's responsibility to review the effectiveness of systems of internal control.

In France and Belgium, a higher proportion of respondents considered that their boards were neither fully aware nor unaware of the significant risks and opportunities facing their company. This degree of indifference is curious as both Swiss and Dutch respondents showed a high level of agreement with the proposition despite having no corporate governance codes or regulations covering this area.

## 5.3 What is the system of internal control?

The system of internal control comprises those elements of an organisation (including its resources, systems, processes, culture and structure) that support people in the achievement of the organisation's objectives.

They facilitate the effectiveness and efficiency of companies by enabling them to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes safeguarding assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed.

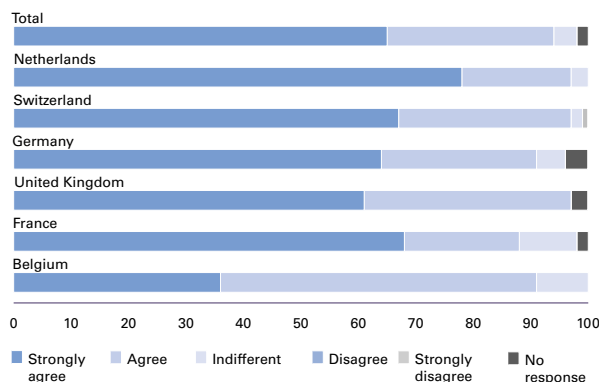
Furthermore, internal controls help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.

Finally, internal controls help ensure compliance with applicable laws, regulations and internal policies.

A company's system of internal control commonly comprises:

- *Control environment* - The control environment sets the

Is the board of directors aware of the significant risks facing the company?



tone of an organisation and influences the control consciousness of its people. It is the foundation for all other components of internal control. Factors include the integrity, ethical values and competence of an entity's people; management's philosophy and operating style; the way authority and responsibility is assigned; the development of people; and the direction provided by the board.

- *Identification and evaluation of risks and control objectives* - Every entity faces a variety of risks from external and internal sources which threaten the achievement of its business objectives. Risk identification and evaluation forms the basis for determining how risk should be managed.
- *Control activities* - Control activities are the policies and procedures that help ensure that risks are addressed. Control activities occur throughout the organisation, at all levels and in all functions. They include a range of activities as diverse as authorisations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
- *Information and communication processes* - Relevant information must be identified and communicated in a timely manner so that people can carry out their responsibilities effectively. Information systems make it possible to run and control the business and deal not only with internally generated data, but also information about the external environment. Furthermore, all personnel must receive a clear message that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others.
- *Processes for monitoring the effectiveness of the system of internal control* - Internal control systems need to be monitored to assess the quality of the system's performance over time. This is accomplished through

ongoing monitoring activities such as regular management and supervisory activity, separate evaluations or a combination of the two. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upwards, with serious matters being reported to top management and the board.

Control should be capable of responding quickly to evolving risks arising both from factors within the company and to changes in the business environment. Risks include not only those related to the achievement of a specific objective but also those fundamental to the viability and success of the company such as failure to maintain the company's resilience or capacity to identify and exploit opportunities. Resilience refers to the company's ability to respond and adapt to unexpected risks and opportunities, and to make decisions on the basis of telltale indicators in the absence of definitive information. Control needs to be 'close' to the associated risks - the shorter the chain, the quicker the reaction.

The cost of control should be balanced against the benefit of controlling the associated risk. Business involves the acceptance of some degree of risk so it is important that the incremental cost of additional control does not exceed the benefit derived from controlling the risk.

The system of internal control must include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken. Problems can occur where individuals are discouraged from reporting actual or potential control weaknesses. This is regularly the case where one individual, often the chief executive officer, dominates and controls the company.

It should not be assumed, without making appropriate enquiries, that breakdowns in internal control are isolated occurrences. Often major disasters are the result of the

accumulation of a number of smaller, seemingly insignificant events, which if analysed collectively would provide the necessary warnings to enable preventative action. The key is continual learning rather than attribution of blame - which often encourages the concealment of breakdowns in control. This philosophy should come down from the top of the company.

Control can help minimise the occurrence of errors and breakdowns but cannot provide absolute assurance that they will not occur. A control system cannot be designed to provide protection with certainty against a company failing to meet its business objectives, or all material errors, losses, frauds or breaches of laws or regulations. Human fallibility and the risk of unforeseeable occurrences are inherent limitations in any system of internal control.

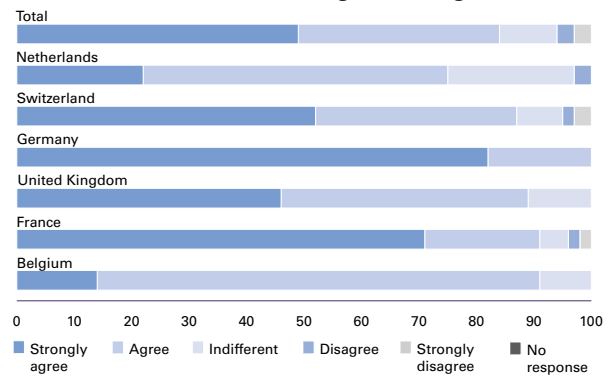
Finally, the system of control should be embedded in the operations of the company and form part of its culture. Control is effected by people throughout the company, including the board, management and all other staff. People who are accountable, as individuals or teams, for achieving objectives should also be accountable for the effectiveness of control that supports the achievement of those objectives. It is important that criteria are in place by which the effectiveness of the system of control can be judged. By making individuals accountable, the likelihood that controls are operated properly is increased.

#### 5.4 Risk identification and evaluation

As discussed earlier, every company faces a variety of risks from external and internal sources which threaten the achievement of its business objectives. The board should formally identify the major business risks (or review the process by which they have been identified and formally endorse the conclusions) and be able to demonstrate that it is aware of the significant risks facing the business.

We asked whether the system of internal control was designed to facilitate the identification of significant risks.

The system of internal control is designed to facilitate the identification, evaluation and management of significant risks



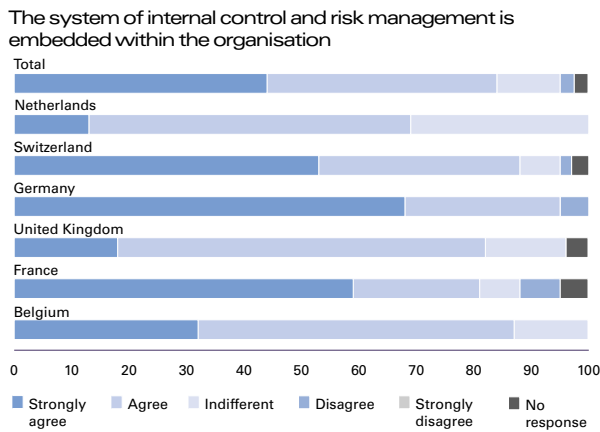
All German respondents and the vast majority of respondents from Belgium and the United Kingdom either agreed or strongly agreed that their system of internal control was designed to facilitate the identification of significant risks. In France, Switzerland and the Netherlands, a small minority of respondents disagreed with the proposition. The positive response from German and United Kingdom respondents may be due to the impact of KonTraG and the Turnbull recommendations.

We also asked whether the system of internal control was designed to facilitate the assessment (ie, probability of occurrence) and management of significant risks. Our findings were similar to those presented in the chart shown above.

### 5.5 Embedding the system of internal control and risk management

Effective systems of internal control and risk management are embedded in to a company’s operations and form part of the corporate culture. Where risk management is embedded, management and staff become more focused on meeting business objectives and managing any significant associated risks.

We asked whether systems of internal control were embedded.



Generally respondents considered that their system of internal control and risk management was embedded within their organisation, though in France, Germany and Switzerland there was a small minority that did not.

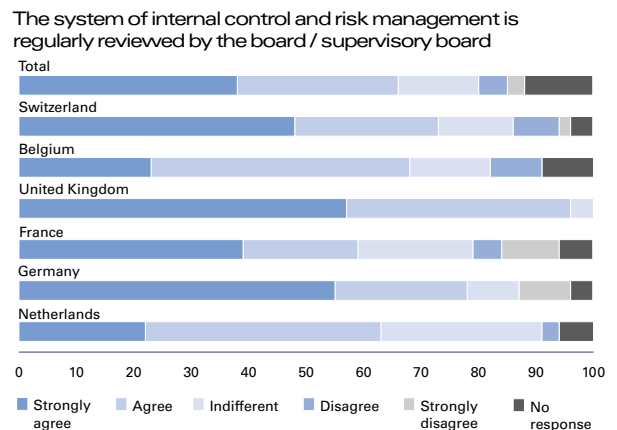
### 5.6 Reviewing the system of internal control and risk management

Effective systems of internal control must be capable of adapting to evolving risks. To ensure that systems of internal control remain effective, they must be regularly monitored to assesses the quality of the system’s performance over

time. This is generally accomplished through ongoing monitoring activities such as regular management and supervisory activity, separate evaluations or a combination of the two.

In the United Kingdom, the Turnbull report recognises that effective monitoring is an essential component of a sound system of internal control, but recognises that the board cannot rely solely on an embedded monitoring process to discharge its responsibilities. Turnbull requires that the board should regularly receive and review reports on internal control and, in addition, should undertake an annual assessment exercise to ensure that it has considered all significant aspects of internal control for the accounting period and the period up to the date of approval of the annual report and accounts.

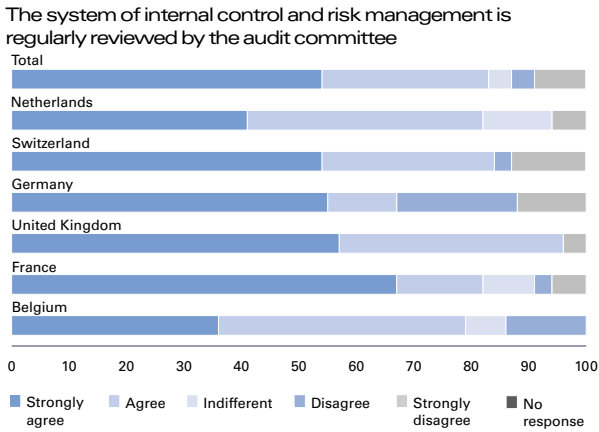
We asked whether the system of internal control and risk management was regularly reviewed by the board (or supervisory board where applicable).



Clearly there is a high degree of compliance with the Turnbull recommendations in the United Kingdom. Switzerland and Belgium reported similar results with around 23% of respondents being indifferent to, or

disagreeing with, the proposition that boards regularly review the system of internal control. In France and the Netherlands over 30% of respondents disagreed or were indifferent to the proposition. It should be noted that there was more indifference than disagreement in the Netherlands.

We also asked whether the system of internal control and risk management was regularly reviewed by the audit committee. (Only respondents with an audit committee are included in the chart below)



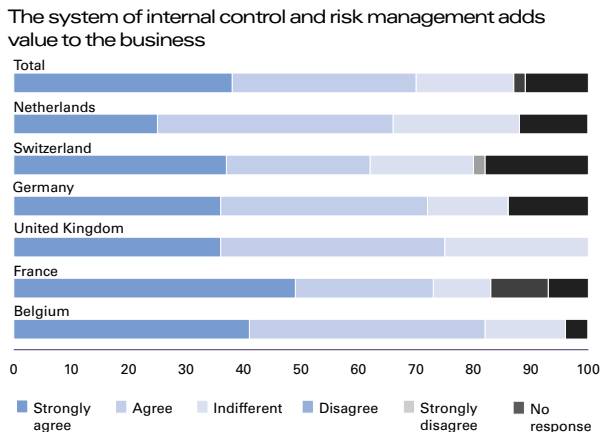
It can be seen that in most countries, audit committees review the system of internal control as well as the board itself. In Belgium, France, Switzerland and the Netherlands, it is more commonplace for the system of internal control to be reviewed by the audit committee than by the board. This may suggest that the board delegates its responsibility in those countries.

In the United Kingdom, 94% of respondents agreed that the system of internal control was reviewed by the audit committee. The same number of respondents reported that the system of internal control was reviewed by the board (see above).

### 5.7 Does risk management add value?

For leading companies risk management is moving well beyond the tradition of risk mitigation (using controls to limit exposure to problems) toward risk optimisation - determining the organisation's risk appetite and capacity among a group of risks across the organisation, seizing opportunities within those defined parameters, and capitalising on the rewards that result. As a consequence, risk management is beginning to be perceived as a new means of strategic business management, linking business strategy to day-to-day risks and then optimising those risks in order to realise value.

We asked whether the system of internal control and risk management adds value to the business.



In general, respondents believed that their system of internal control and risk management added value to their business. Those agreeing (or strongly agreeing) with the proposition ranged from 62% in Switzerland to 82% in Belgium.

Only 2% of respondents (from Switzerland) did not believe that their system of internal control and risk management added value to their business.



6	Internal and external audit	43
6.1	Existence of internal audit	44
6.2	Communication between auditors and the audit committee	44
6.3	Relative values of internal and external auditors	45

## Internal and external audit

Internal audit has the potential to be one of the most influential and value-added services available to the board. When objective and adequately resourced, an internal audit function - or its equivalent where, for example, a third party is contracted to perform the work concerned - should be in a position to provide the board with much of the assurance it requires.

The Institute of Internal Auditors define the primary role of an internal audit function as providing reasonable assurance to executive management and the Board about the adequacy and effectiveness of the risk management control framework in operation. The secondary role is to strengthen and improve the risk management and control framework through the promulgation of best practice. As such, an effective internal audit function acts as a change advocate.

### 6.1 Existence of internal audit

A high proportion of respondents from the United Kingdom and Germany (86%) reported the existence of an internal audit function. This is to be expected as both the Turnbull report and KonTraG give a strong steer in this direction. What is surprising, however, is that many respondents, particularly in Belgium, Switzerland and the Netherlands, do not have such a function. The obvious question is how do the boards of such companies gain assurance over the adequacy of their systems of internal control?

It is perhaps worth noting that the Combined Code recommends that companies that do not have an internal control function should from time to time review the need for one. Turnbull goes further in recommending that such reviews be carried out annually. Furthermore, Turnbull recommends that boards should annually review the scope, authority and resources of internal audit where such a function exists.

### 6.2 Communication between auditors and the audit committee (or supervisory board)

For unitary boards, an active, well-informed audit committee is indispensable to the implementation and maintenance of an effective control environment. If the audit committee is to fulfil its duties effectively, it is not unreasonable to suggest that there should be clear lines of communication between auditors and the audit committee.

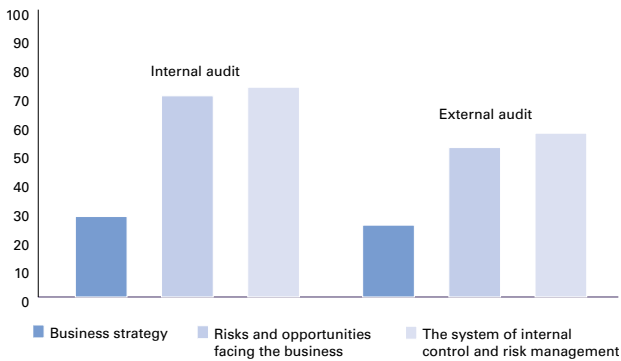
In two-tier board structures, the rationale for an audit committee is less convincing as the supervisory board is itself an oversight body. Nevertheless, audit committees may have a significant role to play as a sub-committee of the supervisory board.

As can be seen below, auditors do not always communicate directly with audit committees (or supervisory boards) on a number of matters.

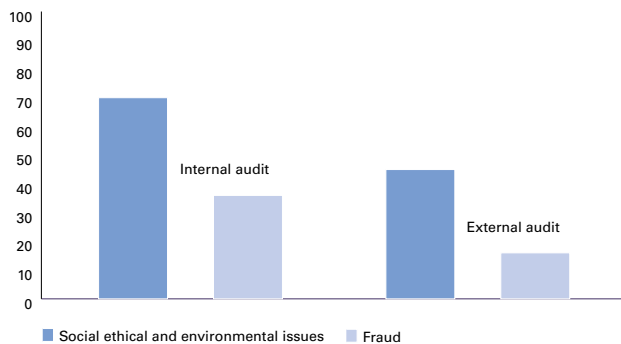
Companies having an internal audit function

	France	Belgium	United Kingdom	Germany	Switzerland	Netherlands	European average
Internal audit function	76%	42%	86%	86%	63%	63%	71%

Communication between auditors and the audit committee



Communications between auditors and the audit committee



Respondents generally considered internal auditors to be more communicative than external auditors on matters such as business strategy, risks facing the business, the system of internal control, social, ethical and environmental matters, and fraud. By contrast, external auditors were considered more communicative than internal auditors in issues such as accounting policies, the financial statements and auditor independence.

The responses suggest that auditors rarely discuss business strategy with the audit committee, yet risks and internal control are commonly discussed. This dichotomy is strange as risk and strategy are intrinsically linked.

### 6.3 Relative values of internal and external auditors

Respondents were generally of the opinion that internal audit functions were well respected within the organisation, seen as a value adding resource and business objective orientated. In Germany, 94% of respondents agreed (or strongly agreed) that internal audit was a value adding resource (this compares with 71% in France, 72% in the United Kingdom and 73% in Switzerland). Only 13% of United Kingdom respondents strongly agreed that internal audit serves as a sounding board for directors compared with 47% and 53% in Germany and Switzerland respectively. No United Kingdom respondents strongly agreed that internal audit was a training ground for senior management, unlike France (23%), Germany (32%) and Switzerland (34%).

Across Europe, external auditors appear to be less valued than their internal audit counterparts in each of the five categories - respected within the organisation; seen as a value adding resource; business objective orientated; sounding board for directors; and training ground for senior management.

National trends are generally similar for both internal and external audit. Auditors of United Kingdom respondents are seen as more business orientated and respected than most of their European counterparts (except Germany where auditors are seen as very business orientated) while German and Swiss respondents looked more favourably on both internal and external auditors as a sounding board for directors and training ground for senior management.



7

Belgium

Corporate Governance  
in Europe

# Belgium

## Corporate governance regime

The corporate governance debate in Belgium is centred around the need to participate in international capital markets, the introduction of the single currency (Euro) and the need for improved transparency with respect to all shareholders, including both national and international institutional investors.

In contrast to the United Kingdom, where companies tend to have a diverse shareholder base, most Belgian companies listed on the Brussels Stock Exchange have only a few dominant shareholders. The Belgian corporate governance debate has therefore focused more on the influence of such dominant shareholders rather than on the power and influence of management.

Towards the end of the last decade, initiatives were undertaken by the Commission on Corporate Governance of the Brussels Stock Exchange (BSE), the Belgian Enterprises Federation (BEF) and the Banking and Finance Commission (BFC). To some extent, each initiative was based on corporate governance recommendations in the United Kingdom.

### Recommendations and codes

Each initiative produced a 'code of conduct' based on the three principles of transparency, integrity and responsibility, rather than binding rules - a formula of recommendations and market regulation. Nevertheless there is a possibility that more detailed regulation will be introduced if the current initiatives are not seen to be working.

Transparency is the basis on which trust between the company and its stakeholders is built, notwithstanding the constraints imposed on the company by its competitive environment. Transparency, or effective dialogue with stakeholders, is conducive to the company's effectiveness because it allows the board to react more quickly to the environment in which the company operates. Consequently potential business opportunities can be maximised and conflicts avoided.

Integrity demands that the financial reports and other information disseminated by the company present an accurate and complete picture of the company's position.

Responsibility primarily relates to the board of directors and the shareholders, both of whom have a role to play if reporting by the board of directors to the shareholders is to be efficient. In addition to its responsibility for setting the company's strategy, the board's other chief responsibility relates to the quality of the information it provides to shareholders.

The Belgian corporate governance codes focus on: the composition of the board of directors; the function of the board; internal control (including the role of internal audit); and transparency.

### Directors

The board of directors is the highest authority within a company and must, in addition to its decision-making duties, exercise full and effective control over the company.

A procedure should be established to ensure that all directors, and in particular non-executive directors, are provided with and have access to adequate information to enable them to perform their duties. Information should be made available to all directors equally. There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice at the company's expense.

The board of directors should not consist of more than 12 members. It is considered that more than 12 members would hinder efficient decision-making and communication.

The board should consist of a majority of non-executive directors of sufficient calibre for their views to carry significant weight in the board's decisions. Non-executive directors are those who do not perform a management function within the company or its subsidiaries. Non-executive directors should bring an independent judgment to bear on issues relating to the company's strategy, performance and resources (including key appointments), and standards of conduct.

A number of non-executive directors should be independent of the executive management and of the dominant shareholders. They should be free from any business or other

relationship with the company which could interfere with their independent judgment, except from their remuneration and shareholdings in the company.

It is recommended that there should be a clear division of responsibilities at the head of a company to ensure a sound balance of power and authority. Where the chairman is also the chief executive, it is essential that there should be strong and independent persons on the board whose authority is acknowledged.

Nomination committees are regarded as good practice. Such committees should carry out the selection process and make recommendations to the board on the appointment of both executive and non-executive directors. Where such a committee exists, it should include a majority of non-executive directors and should be chaired by the chairman of the board or a non-executive director. Non-executive directors should be selected through a formal procedure. Both this procedure and proposals for the nomination of non-executive directors should be a matter for the board as a whole.

In accordance with Belgian law, directors must be appointed for specified terms which must not exceed six years. Reappointment should not be automatic.

### Directors' remuneration

Remuneration committees are regarded as good practice. Such committees should consist entirely of non-executive directors and should advise on the remuneration of executive directors. Where a remuneration committee does not exist, the non-executive directors should decide on the principles of executive remuneration.

The remuneration of non-executive directors should reflect the amount of time they commit to the company. Their remuneration should not be performance-related, but may be related to the value of the company (ie, remuneration can take the form of company shares). It is recommended that the remuneration of non-executive directors should not take the form of share options, nor should they participate in their company's pension scheme.

The aggregate amount of directors' remuneration should be disclosed separately in the annual report with both the fixed and the variable part of remuneration specified. In addition, the principles underlying the calculation of any variable remuneration should be disclosed.

### Accountability and audit

Without prejudice to its statutory duties, the board of directors is responsible for defining a company's strategic objectives and for approving the structures designed to facilitate the achievement of those objectives. It is also the board's task to supervise the implementation of policy and the control of the company and to report to the shareholders. Furthermore, the board of directors is responsible for ensuring that executive management develops and implements the tools necessary to allow appropriate and effective internal control.

Certain directors - whether executive or non-executive - may be given special responsibility for certain areas, on which they report to the full board. Irrespective of the special powers vested in individual directors, the board of directors as a whole retains responsibility for fulfilling its obligations. Thus the board operates on the principle of collective responsibility, with no one category of directors exerting greater influence than any other.

It is recommended that audit committees, consisting of at least three non-executive directors, should be established as sub-committees of the main board, to whom they are answerable and to whom they should report regularly. They should have written terms of reference which deal adequately with their membership, authority and duties. Audit committees should meet at least twice a year. Membership should be confined to the non-executive directors, a majority of which should be independent directors. The membership of the committee should be disclosed in the annual report.

The audit committee should have explicit authority to investigate any matters within its terms of reference, to have available the resources which it needs to do so and to have

full access to information. The committee should be able to obtain outside professional advice and, if necessary, to invite outsiders with relevant experience to attend meetings.

The audit committee should enter into dialogue with the internal and external auditors (including statutory auditors) at least once a year. Executive directors may be excluded from such meetings. The committee should ensure that the auditors have no relationship with the company, whether directly or indirectly, which could influence their judgment.

### Disclosure

The recommendations of the Banking and Finance Commission set best practices regarding the disclosure of information. This includes information about the composition of the Board of Directors, the functioning of the Board of Directors, the Committees created by the Board, daily management, company's policy with regard to the appropriation of the results and the relationship with the dominant shareholders.

## Corporate governance survey

### The board

Unlike some other European corporate governance codes, the issue of ownership and control is not the principle focus of the Belgian codes. There is little dispersion of shareholders' ownership and the corporate governance codes emphasize transparency, integrity and responsibility rather than accountability. Yet, the codes do highlight the need to separate the roles of chairman and chief executive officer so as to ensure a clear division of responsibilities at the head of a company. Fifty per cent of the Belgian respondents strongly agreed with this recommendation.

The Belgian codes of conduct suggested that there should be "a majority of non-executive directors on the board". Therefore it is not surprising that the average board of the Belgian respondents comprises 65% of non-executive directors of which 24% of them are considered independent directors. Board size is more varied in Belgium than in Switzerland and the United Kingdom.

The majority of Belgian respondents met four times in the last financial year as opposed to the majority of United Kingdom boards who meet at least seven times per annum.

It should, however, be noted that attendance of the board meetings is very high in Belgium; 87% of board members attend each board meeting.

### Independence

All of the respondents to the Belgian survey suggested that a non-executive director is independent "when they are independent from management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement". This is in fact one of the recommendations made by the Banking and Finance Commission in Belgium. Other key elements of independence are that directors must not have conflicts of interest with management with other board members (86%); that they must not receive any income from the company other than directors' fees (82%); and that they must not represent a significant stakeholder (82%).

### Stakeholder representation and communication

It appears that non-executive directors in Belgium see themselves as valuable in developing the relationship between the board and shareholders. It also appears that executive directors frequently enter into spoken communication with shareholders, lobby organisations and customers. Many respondents enter into such communications each day.

### Specialised committees

#### Audit committees

Audit committees are widespread in Belgium with 59% of respondents reporting their existence. However, prior to the recommendations of the Belgian corporate governance codes, only 5% of Belgian companies had an audit committee.

In common with the United Kingdom, Belgian audit committees tend to have a greater number of independent directors than many other countries who responded to this survey.

### Remuneration committees

The Banking and Finance Commission regards it as good practice to install a remuneration committee consisting of only non-executive directors. Of those who responded to the survey, only 19% were in compliance with the code and had no executive directors on their remuneration committees. However, 69% of remuneration committees comprised a majority of independent directors. This is in line with the European average.

### Nomination committee

The Belgian corporate governance codes recommend that nomination committees be established, yet only 32% of the respondents reported the existence of such a committee.

### Internal control and risk management

Only 36% of the Belgian respondents strongly agreed that their board was fully aware of the risks as opposed to 68% of boards in France, 61% in the United Kingdom and 64% in Germany.

French and German respondents strongly believed that their organisations were fully aware of the significant opportunities facing them (France 67% and Germany 63%). Also, they felt confident that they had effective systems of internal control (France 67% and Germany 63%). Belgium, on the other hand, does not share this confidence as only 19% strongly believed that effective systems of internal control were in place.

When asked whether the system of internal control assisted in the recognition, evaluation, monitoring and reporting of significant risks, the vast majority of Belgian respondents either agreed or strongly agreed.

Most Belgian respondents agreed that both audit committees and boards regularly reviewed their system of internal control and risk management. This would seem to be a common practice across Europe.

### Internal and external audit

The Belgian respondents were usually of the opinion that their internal audit function was well respected within their organisation. It was also seen as adding value to the organisation. They were however mixed opinions on whether their internal audit is business objective oriented.

### Disclosure

It is encouraging that almost all the information published in the annual report and accounts is also available on the internet. Detailed information about environmental policies and performance, including compliance with relevant laws and regulations does not seem to be as readily available as in other countries such as the United Kingdom. However, the survey does suggest that disclosure of key relationships and known events trends and uncertainties that might affect future performance is prevalent.



8

France



## France

### Corporate governance regime

The French government has traditionally been an important stakeholder. This is partly as a result of the government's direct shareholdings in French industry though this has reduced in recent years as a result of various privatisation programmes. It is also partly due to the circulation of senior executives between the civil service and the boardroom, a relationship said to be enhanced by the education system which produces both management and government officials that share a common outlook.

Historically, the French capital market has not been as liquid as some other developed markets. French companies are characterised by a strong influence of foreign shareholders, in particular foreign institutional investors. Financing has traditionally been focused on debt rather than equity, although, in the 1980s this trend has been reversed.

During the last decade, steps have been taken to reform governance structures and improve the efficiency and competitiveness of the stock market.

#### The basic framework

There are two governance systems available to French listed companies. The unitary system is based on the formidable power of the *Président Directeur Général* (PDG) who deals with much of the day to day running of the company. This system is favoured by most listed companies. Alternatively, there is the option of a two-tier board system similar to that adopted in Germany.

The law specifies certain powers for both shareholders and the board of directors. The PDG has the widest powers to direct and manage the company and, unless problems arise, boards often remain passive. Nevertheless, boards do have certain specified powers such as the appointment and removal of the PDG, the approval of the annual accounts, the approval of significant transactions and the determination of the PDG's remuneration.

Other significant characteristics of French corporate governance are as follows:

- Cross-shareholdings, which are on the decline as a

consequence of privatisations, have allowed a small number of shareholders to retain control of companies through a series of indirect stakes.

- Until recently, directors were allowed to sit on no more than eight boards. This limit included a few but significant exceptions, such as subsidiaries of companies of which they are already a director and foreign companies. Viénot (see later) recommended that executive directors should limit the number of outside directorships to five, and following the reforms introduced by the New Economic Regulations in 2001, this is now part of French law. Notwithstanding this limit, a large number of directorships are held by a relatively small group of individuals.
- Until recently, shareholders rights could be restricted by limiting the number of votes per share. This could act as an effective anti-takeover device where, in certain circumstances, some shares may be granted double voting rights. This system is now forbidden for new share issues. Nevertheless, such rights are maintained where they already exist.
- Workers committees must be consulted in certain circumstances, though there is no requirement for employees to have representatives on the board.

Until the New Economic Regulations came into force in 2001, the government had generally refrained from introducing corporate governance reforms, leaving the private sector to react to concerns such as privatisation, the increasing presence of foreign shareholders (in particular US pension funds), the emergence of pension funds and the reform of the financial market.

#### Recommendations and codes

The first corporate governance report was published by the Viénot Committee in 1995. The committee was commissioned by two employers' federations supported by leading private sector companies. The Viénot Committee published its second report in 1999.

The Association Française de la Gestion Financière (AFG - ASFFI) published a further report on corporate governance in 1998, but its impact was not significant as that of the two Viénot reports.

### Directors

As discussed above, there are two governance systems available to French listed companies - the unitary system and, although not generally favoured, a two-tier system similar to that adopted in Germany. Whichever system is adopted, every company should be headed by an effective board which should lead and control the company. Directors should be provided with information prior to meetings and on a continuing basis which is sufficient, relevant and of such quality, so as to enable them to perform their duties effectively.

Under French law, boards must be composed of at least three, but less than 18 directors (24 before the introduction of the New Economic Regulations). However, the AFG recommended that to ensure the board functions properly, the upper limit should be restricted to sixteen, and include at least two independent non-executive directors. By contrast, the Viénot report recommends that Independent directors should comprise at least one third of the board.

Directors are considered independent when there is no relationship with the company, of any kind whatsoever, that may jeopardise the exercise of their free judgement.

Viénot recommended that executive directors should limit the number of outside directorships to five. Following the reforms introduced by the New Economic Regulations, this is now part of French law.

The identity of board members and the number of meetings during the year should be disclosed in the annual report. In addition, disclosure is required of each director's term of office, their major executive position and any other directorships in listed companies.

Until recently, the roles of Chairman and CEO were not separated in companies with a single tier board. Following the New Economic Regulations, separation is now an

option. Separation was favoured by the AFG report, though the second Viénot report maintained that separation should be optional.

The Viénot report recommended that, in order to enable the shareholders to vote on their appointment or re-appointment with sufficient frequency, the duration of a director's term of office should not exceed four years. French law requires that directors appointments must not exceed six years.

Both the Viénot and AFG reports recommend that boards have nomination committees responsible for proposing candidates to the board. Viénot recommends that independent directors should account for at least one third of the members of such committees and that the company chairman should be a member, but not the committee's chairman. The AFG report recommends that nomination committees should comprise three to five directors and include the chairman and at least one independent non-executive director.

The identity of nomination committee members and the number of committee meetings during the year should be disclosed in the annual report.

### Directors' remuneration

Both the Viénot and AFG reports recommend that companies should establish remuneration committees. Viénot recommends that such committees should have a majority of independent directors. By contrast, the AFG recommend that remuneration committees should comprise at least three non-executive directors, one of which must be independent. The identity of remuneration committee members should be disclosed in the annual report.

The Viénot report recommends that the annual report include comprehensive remuneration disclosures (including the principles for determining bonuses and fixed and variable elements of remuneration) but stops short of recommending disclosure of individual pay packages. However, following the reforms introduced as part of the New Economic Regulations, the law now requires that each director's remuneration be disclosed in the annual report.

## Accountability and audit

Other than specific guidance directed at certain companies within the financial sector, there are no regulations, code provisions or other authoritative guidance concerning internal controls and the associated responsibilities of directors.

Both the Viénot and AFG reports recommend that companies should establish audit committees. Viénot recommended that independent directors should account for at least one third of audit committee members. By contrast, the AFG recommend that such committees should comprise at least three non-executive directors, one of which must be independent.

Viénot recommends that the audit committee should give consideration to the appropriateness of accounting policies and confirm the independence of the external auditors. In addition, each year, the audit committee should submit to the board a report concerning the work carried out by the auditors and their related fees.

The identity of audit committee members and the number of committee meetings during the year should be disclosed in the annual report.

## Corporate governance survey

The questionnaire was sent to the 250 companies listed on the SBF 250 in May 2001. The response rate was 16%. The 41 responding companies include 18 CAC 40 listed companies, 12 SBF 120 (excluding CAC 40 companies), and 11 SBF 250 (excluding SBF 120) listed companies, of which 24 (59%) fall within the European top 500.

The highest response rate responses came from the CAC 40 listed companies where many shares are held by foreign institutional investors. Companies at the lower end of the SBF 250 are more frequently controlled by a single majority shareholder or family and are less concerned with corporate governance developments.

## The board

Twenty-eight percent of respondents have adopted a two-tier board structure and therefore separated the management and control functions. The remaining respondents had unitary boards.

Usually boards meet once every three months, though in some companies meetings are more frequent. More frequent meetings usually coincide with significant events such as major acquisitions, asset transfers and bond issues.

Turning to the definition of independence, most respondents identified with the definition offered by the Viénot Committee ie, *“independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.”*<sup>6</sup>

On 41% of French boards, less than one-third of directors are independent, whereas 37% have a majority of independent directors. This dichotomy may arise because a significant number of French listed companies are still family-owned or otherwise closely controlled. These companies tend to have few independent directors. Conversely, companies whose shares are publicly held, and especially those with institutional shareholders, have gone beyond the recommendations of the Viénot report, and have many independent directors.

Also there has been considerable resistance in France to the imposition of principles that some have thought apply better to other cultures. Debate has hinged on the perception of an independent director with many feeling that the degree of independence of a director was irrelevant if that director was performing well. It is worth noting that the definition of independence in the first Viénot report was subsequently relaxed in the second Viénot report.

## Board evaluation

On the question of processes in place in the company for the regular evaluation of their boards and their audit committees, France lags behind most other European countries. Only 10% of respondents had established a

<sup>6</sup> Recommendations of the Committee on Corporate Governance chaired by Mr Marc Viénot.

process for the regular evaluation of the board while 13% of respondents had a process in place for the evaluation of the audit committee. This compares to the European average of 17% and 22% respectively.

### Audit Committee

The survey reveals that 80% of French companies have established an audit committee - this exceeds the European average of 67%. Most audit committees were established after 1995 and their popularity rose sharply following publication of the initial Viénot report.

While now commonplace, audit committees in France appear to comprise fewer independent members than some other European countries, most notably, the United Kingdom. In France, 21% of respondents' audit committees comprised solely independent directors. This compares unfavourably with the United Kingdom (82%) and the European average (44%). Nearly a quarter of respondents had audit committees comprising less than one-third independent directors.

Only 52% of audit committees review the work of internal audit and verify that their recommendations are implemented. This is surprising as respondents from elsewhere in Europe (except Germany) considered this to be an important part of an audit committee's role.

### Internal control and risk management

Respondents generally agreed that their board was aware of the significant risks and opportunities facing their company, and that an effective system of internal control and risk management was in place. Nevertheless, opinions appear to be linked to both the capital structure and the size of respondents' companies. All respondents from the CAC 40 agreed their board was aware of the significant risks and opportunities facing their company, and that an effective system of internal control and risk management was in place. On average 20% of companies falling within the bottom 130 companies in the SBF 250 disagreed.

It is interesting to note that audit committees review the system of internal control as well as the board itself. In France, as in some other European countries, it is more commonplace for the system of internal control to be reviewed by the audit committee than by the board.

### Internal and external audit

Many respondents (73%) have an internal audit function. Respondents generally agreed that internal audit was well respected and seen as adding value to the organisation.

Turning to communication between auditors and the audit committee, French results are very close to European results except for communications concerning fraud where only 24% of respondents considered external auditors to communicate with the audit committees. This compares unfavourably with the European average of 45%.

### Disclosure

In common with respondents from elsewhere in Europe, almost all the information published in the annual report and accounts is available on the internet. The extent of information reported by companies is clearly expanding and detailed information about strategy, environmental and social issues is now made available by many companies. It is likely that shareholders and stakeholders will increasingly demand relevant and reliable information on such issues in the future.



9

Germany

# 9

## Germany

### Corporate governance regime

In recent years, corporate governance has been a subject of debate in many countries, including Germany. Compared with other European countries the legal framework in which German companies operate is highly specific. Firstly, German companies operate under the two-tier concept according to which there is a clear distinction between the management board and the supervisory board. Secondly, the responsibilities of those boards and the general meeting is laid down in detail in the Stock Corporation Law (Aktiengesetz). As a response to significant changes in the economic environment in the mid-nineties, such as globalisation, the increasing importance of capital markets for corporate financing and the growing information needs on the part of investors, in 1998 the legislator passed the Law for Control and Transparency of companies (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich - KonTraG). The key issues of KonTraG are as follows:

- Obligation of the management board of stock corporations to set up a risk management system (literally “risk early recognition system”) which falls within the scope of the annual audit for companies in a particular segment of the stock exchange (Amtlicher Handel).
- Additional disclosure (for example the management report has to include the risks of future development).
- Improvement of the external audit and the collaboration of the external auditor and the supervisory board. The aim is to emphasize the auxiliary function of the external auditor for the supervisory board and the auditor’s independence from management.
- Numerous supplementary provisions concerning, in particular, the responsibilities of the management board, the supervisory board, and the external auditor.

Nevertheless corporate failures as well as the problems of numerous companies at the New Market, the stock exchange segment for high-tech companies, continuously fuel the discussion on corporate governance and the need for further reforms.

The aim of such reforms will be to restore confidence in shares as an investment and to ensure the competitiveness of the structures and processes of company management and supervision. The confidence of foreign and domestic investors must be strengthened so as not to jeopardise the position of German companies in the global capital market. At a national level these objectives have recently become even more important since shares may now be included in German retirement arrangements.

#### The basic framework

Shareholders exercise their rights in respect of the company’s affairs via the annual general meeting. The general meeting elects part of the supervisory board (the shareholder representatives) and the auditors and has the authority to remove those members of the supervisory board. Due to various laws about co-determination the supervisory board also comprises a high number of employee-representatives. Depending on the size of the company up to 50% of the non-executive directors are nominated by the employees or the unions. While the management board has full and exclusive operational responsibility the supervisory board has supervisory control.

Under the provisions of the Stock Corporation Law the management board is responsible for managing the company subject to a duty of care. It is also required to report to the supervisory board on matters such as corporate strategy, profitability, significant transactions, the development of the business and the state of the company’s affairs. The position of the supervisory board as a body of control with regard to the management board was further strengthened by KonTraG. For example, the frequency of meetings was increased from two to at least four per annum and the duty to examine the financial statements and management report was extended to the group financial statements and group management report. Additionally, broadening the rights and duties of the management board influences the control function of the supervisory board as well; for example, the management board’s obligation to install a risk management system leads to the duty of the supervisory board to oversee whether this has been done appropriately.

## Recommendations and codes

In addition to existing legislation, corporate governance principles and recommendations have recently been developed. These are guidelines and do not have the force of law.

- Corporate Governance Rules for Quoted German Companies (Code of Best Practice) of the German Panel on Corporate Governance (originally published in January 2000, revised edition July 2000) - includes principles for the achievement of responsible management and control of quoted companies and groups, aimed at creating value.
- Scorecard for German Corporate Governance of the German Association of Financial Analysts, Portfolio Managers and Investment Consultants (DVFA) (July 2000) - practical analysis tool for analysts, investors and companies for evaluation of the competence, communication and control of decision-making bodies of quoted companies (based on the Corporate Governance Rules for Quoted German Companies).
- German Code of Corporate Governance (GCCG) of the Berlin Initiative Group (June 2000) - contains recommendations on the formulation of a framework of rules for the management and supervision of companies carrying out their value-creation activities in and from Germany. The focus is on cross-company core governance processes. There is little focus on the supervisory board.
- Effects of KonTraG on the supervision of companies (September 2000) published by the working group “External and Internal Control of Companies” of the Schmalenbach-Gesellschaft für Betriebswirtschaft e.V.
- Report of the German Government Committee on Corporate Governance (July 2001) - the aim of the recommendations is to improve corporate management and supervision, transparency and competition and shareholder protection as well as to strengthen Germany’s financial market.

In accordance with the recommendations of the Government Committee on Corporate Governance a further committee has been appointed to work on a Code of Corporate Governance. This code will not be fixed in law. This has the advantage of creating a flexible instrument that can be adapted quickly and easily to the changing requirements of the capital market and investors. In addition the federal government is drafting a ‘Transparency and Disclosure Act’ which will not only provide the legal framework for the code but also implement a number of legal changes proposed by the Government Committee. The draft Act will include the principle ‘comply or explain’ according to which public listed companies will have to state in their annual reports whether they observed the Code of Corporate Governance or, if not, point out the reasons why they did not follow its recommendations. At some future date, the report of the Government Committee may serve as a foundation for a comprehensive reform of corporation law and accounting regulations.

The following paragraphs briefly describe some of the recommendations of the Government Committee on the establishment of a corporate governance code extending beyond the existing legal requirements. Other corporate governance initiatives are taken into account where necessary.

### Directors

The recommendations of the Government Committee on standards of behaviour for company management and control builds on KonTraG in order to reinforce transparency and responsibilities. Although the two-tier model is viewed critically, it is not regarded by any of the corporate governance initiatives as being fundamentally in need of modification, as there is currently no empirical evidence that the single-board system is superior to the dual system.

The Government Committee suggests that in the management board’s reports to the supervisory board on the intended business policy and other principal issues of corporate planning, any deviation from previously set

targets must be disclosed and reasons must be given for such deviations ('follow-up reporting'). It is proposed that these reports must as a rule be made in writing and be submitted to the supervisory board members in a timely fashion.

With regard to the composition of supervisory boards the Government Committee makes no recommendations on the maximum number of its members, since arguments exist for both smaller and larger boards. However, the Code should include a recommendation that would prohibit a person who serves on the supervisory boards of five other non-affiliated companies from becoming a supervisory board member of a public company as well as a recommendation that supervisory board members may not hold office in or represent other companies that are in competition with the company in which they serve on the supervisory board.

The Government Committee proposes that the committee which works on the Code of Corporate Governance considers the issue of independence of supervisory board members by addressing the problems that arise, for example, by the special situation of co-determination. The German Panel on Corporate Governance states in this context that independent directors are those with no current or former association with the company and recommends that retiring members of the management board should not as a rule be elected to the supervisory board.

#### Directors' remuneration

The recommendations of the Government Committee concerning the management board members' remuneration are restricted to the incorporation of stock-based or incentive-based remuneration into the already existing description of the total remuneration of individual management board members which is included in the Stock Corporation Law. In this context the Corporate Governance Rules for quoted German Companies outline that the management board directors' remuneration should provide appropriate incentives for the improvement of the company's value. It sets out that the fixed and variable remuneration elements of the management board's remuneration shall be detailed in the annual report.

The different initiatives make no explicit recommendations on the remuneration of supervisory board members. While the Government Committee sets out that an increase in the variable portion of the remuneration is desirable, the German Panel on Corporate Governance states only that the supervisory board members' remuneration should be appropriate and indications on share ownership by the supervisory board should be given in the notes.

#### General meeting, shareholders' rights and investor protection

The general meeting constitutes the decision-making body of the shareholders and provides an opportunity for the directors to enter into a constructive dialogue with shareholders about the progress of the company. The recommendations of the Government Committee on the exercise of these fundamental functions relate in particular to arrangements for use of the Internet as an electronic medium. For example, the notice of the general meeting should be published in an electronic form of the Federal Gazette. The financial calendar, reports and documents should also be made available for inspection by the shareholders via company's websites. It is also recommended that the company's articles of association should allow shareholders not to participate directly in the general meeting but to exercise their rights by means of electronic communication. Members of the supervisory board should be able to participate in the general meeting by any effective means. In well founded and exceptional cases, this may be by means of electronic, telephone or video communication.

The Government Committee recommends the use of communication media like the internet to facilitate communication and to provide shareholders with more current and consistent information. A regulation that all shareholders get access to information that is communicated to financial analysts and similar persons is likely to be adopted in the Code of Corporate Governance. Another important point is that the legislation should provide that directors of publicly listed companies will incur civil

liability for releasing false information about the company's situation intentionally or through gross negligence. In those cases the Government Committee recommends that common representation of investors be allowed.

## Accounting

The Stock Corporation Law requires that the management board ensure that the required books of account are kept, while it is the supervisory board's responsibility to examine and inspect the books and to mandate the audit of the financial statements.

The Government Committee stresses the importance of international comparability and recommends that the German government supports the endeavours of the European Commission to implement uniform international accounting standards for consolidated financial statements as from 2005. Furthermore, it is proposed that public companies should be required to produce interim financial statements. To improve the availability of information to all shareholders, it is recommended that these are made accessible rapidly and centrally, including in electronic form. A review of interim reports by external auditors is also favoured.

## Auditing

The audit obligation is set out in the commercial code and, in contrast to most other countries, covers not only the financial statements but also the management report. Accordingly the auditor gives his opinion whether the annual financial statements give a true and fair view of the net assets, financial position and results of operations in accordance with principles of proper accounting and whether, on the whole, the management report provides a suitable understanding of the company's position and suitably presents the risks of future development.

With its recommendations on auditing, the Government Committee intends to further strengthen this instrument of control. The audit helps to safeguard the interests of shareholders and the capital market and provides assurance to companies and their management. It is proposed to extend

the audit of the risk management system to all public companies. To date, this is only required for companies that are officially quoted (Amtlicher Handel).

In order to demonstrate independence, it is recommended that external auditors provide details to the supervisory board or its audit committee on any circumstances that might be relevant to the auditor's independence.

## Audit committees

The rules for the formation of committees are embodied in the Stock Corporation Law. However, traditionally, few audit committees have been established due to the two-tier board system. While the Government Committee makes no explicit recommendations on this subject, the working group of the Schmalenbach-Gesellschaft is in favour of the formation of audit committees where supervisory boards of public companies are sufficiently large.

Implementing an audit committee can increase the efficiency of supervisory role, strengthening not only the position of the supervisory board and the auditor but also increasing the confidence in the effectiveness of corporate governance practices. The Stock Corporation Law requires that final decisions are the responsibility of the supervisory board. Consequentially, an audit committee which always consists of supervisory board members can only fulfil preliminary tasks, such as: reviewing (consolidated) financial statements and management reports, evaluating the risk management system, analysing profitability and discussing key aspects of the annual audit with the auditor.

## Corporate governance survey

The questionnaire was sent to all 100 DAX- and MDAX-companies in June 2001. The response rate was 22%. The 22 responding companies include seven DAX-listed companies and 15 MDAX-listed companies, of which ten companies belong to the Europe 500. Of the 19 financial and insurance institutions listed on the DAX 100, seven (37%) responded. From the industrial sector, 15 responses (19%)

were received. The response rate of 22% cannot be attributed to disinterest among companies in corporate governance issues. Many companies expressed an interest in the subject but, because of the large number of surveys they received, did not find themselves in a position to respond to the questionnaire. The reason for this is that questions concerning corporate management and supervision have become increasingly important in Germany. The recent report of the Government Committee which recommends a corporate governance code has resulted in companies no longer being able to ignore the issue. As a result, many companies find themselves in the midst of a process of change with respect to the development and implementation of the relevant principles.

#### *The board*

According to the survey, there are an average of five members on the management board and 13 members on the supervisory board. This means that German companies tend to have a higher number of supervisory board members than French, Swiss or United Kingdom companies have board members.

Whereas the management board meets frequently throughout the year (an average of 32 times), the results from the survey confirm that the supervisory board meets four to five times a year. This is compliant with the provisions of the Stock Corporation Law; however, the existing corporate governance codes, as well as the recommendations of the Government Committee, envisage an increase in the number of supervisory board meetings.

#### *Independence*

On the question of independence of supervisory board members, most respondents agreed with the definition offered in the questionnaire - independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. In this context, it appears to matter less in German companies whether or not an active supervisory board member is a former member of the management board

or a former employee of the company. However, what plays an important role in ensuring independence is the fact that the supervisory board member must not have conflicting or cross directorships nor personal or financial interests in the company or its management which could interfere with the director's loyalty to shareholders.

To the question, which criteria play a role in the appointment of members to the management or supervisory board, more than 80 % of the respondents put experience at the top of the list, followed by professional expertise and relevant training and education. Candidates for the supervisory board should, in addition, be independent. Only about 50% of responding companies make public the criteria they applied in the appointment of their current board members.

#### *Board evaluation and training*

On the question of processes in place in the company for the regular evaluation of the different bodies, Germany lags behind the United Kingdom but is superior to the average of the European companies when it comes to assessing the performance of the management and supervisory boards. At the same time, the supervisory boards of 82% of the responding companies carry out an assessment of the management board, which is more than the European average. Additionally, the results of the survey show a further need concerning the training of future directors. Under a third of respondent companies give appropriate training on the first occasion that a director is appointed to the board, and subsequently as necessary.

#### *Audit committees*

The survey shows that the number of German companies that have set up an audit committee lags behind other European countries. This is not due to inadequate implementation of corporate governance practices, but to the fact that historically the benefits of audit committees have not been appreciated in those companies operating two-tier board systems. Nevertheless in all countries surveyed there is a trend of an increasing number of audit committees which is also true for Germany.

### Internal control and risk management

In Germany, companies rate their own risk awareness as very high. For example, there is full agreement with the statement that the supervisory board is aware of the risks faced by the company. Companies generally rate their internal control and risk management systems as good. These positive results are certainly due to KonTraG. Additionally all of the German respondents agreed to the statement that the internal control and risk management system is designed to facilitate assessment, monitoring and reporting of significant risks.

While the internal control systems of German companies appear to have a good to very good understanding of issues such as market share, products and processes, as well as research and development, there still appears to be room for improvement with respect to issues such as the environment, intellectual property, health and welfare and employee satisfaction. This could be because, unlike the first group of criteria, the latter ones are difficult to quantify.

### Internal and external audit

Nineteen responding companies have internal audit functions which mostly comply with the guidelines for internal audit of the German Institute of Internal Audit. Usually, they report directly to the chairman of the management board.

It is noteworthy that European companies have a high regard and respect for both internal audit and external audit. This applies in particular to Germany. Although most companies consider internal audit as a value-adding resource, this is not generally the case with respect to external audit. In Europe, only about one third of companies see external audit as a value adding resource, whereas in Germany, two thirds of companies do. The external auditor forms a more important discussion partner for German supervisory and management boards than the internal auditor.

### Disclosure

With respect to disclosure, the survey shows that the internet and the annual report are used equally to communicate information. In general, information about the organisation's purpose, strategy and principal drivers of performance are made publicly accessible. At the same time the survey reveals an information deficit with regard to issues such as environmental policies and performance and measures relating to ethics, social responsibilities and reputation, as well as key relationships with employees, customers and suppliers.



10

Ireland

Corporate Governance  
in Europe

## Ireland

### Corporate governance regime

The corporate governance regime in Ireland is not dissimilar to the United Kingdom - shareholders elect directors, who manage the company on their behalf and report back on their stewardship at shareholder meetings, at which they can either be re-elected as directors or dismissed.

Historically, companies in Ireland have adopted a unitary board comprising both executive and non-executive directors. The chairman is usually, but not always, a non-executive director. Executive and non-executive directors have different functions within the company, but the same responsibilities under the law.

The responsibilities of the board include setting strategic objectives, supervising management and reporting to shareholders on its stewardship. Non-executive directors contribute to the formulation of strategy and often fulfil a specific supervisory function through membership of audit and remuneration committees.

#### The basic framework

The basic legal framework is not unlike that in the United Kingdom. While the law requires directors to have regard to the interests of employees and to those who have contracts with the company, there is no requirement for any specific group (eg, employees) to be represented on the board.

Company law covers the appointment and removal of directors; strict and well defined categories of what directors must not do (eg, various transactions with directors); the appointment of auditors; disclosure of directors' interests and remuneration; annual reporting requirements; and the conduct of annual general meetings.

In addition to the legal framework, the governance regime includes various regulatory requirements. The principle amongst these are the Listing Rules of the Irish Stock Exchange and the Combined Code appended to those rules (see United Kingdom section).

#### Recommendations and codes

The Combined Code contains 14 corporate governance principles and 45 detailed provisions applicable to listed

companies. As in the United Kingdom, the Listing Rules of the Irish Stock Exchange (which are similar to those of the UK Listing Authority) require listed companies to include in their annual report and accounts a narrative statement explaining how the principles have been applied, together with a statement setting out the extent of compliance with the detailed provisions and reasons for any non-compliance. A company's external auditors are required to review the latter statement before publication, but only in so far as it relates to seven of the 45 Code provisions. The key provisions of the Combined Code are addressed in chapter 14.

Until recently, listed companies were required only to disclose aggregate directors' remuneration, analysed into executive and non-executive elements. However, for accounting periods beginning on or after 1 January 2000, the Irish Stock Exchange require that the annual report and accounts should include full details of all elements in the remuneration package of each individual director by name - including basic salary, benefits in kind, annual bonuses, pension entitlements and long-term incentive schemes including share options. This brings the Irish position into line with the United Kingdom.

### Corporate governance survey

#### The board

In Ireland, the separation of the roles of chairman and CEO is widely recognised as advantageous. Nevertheless one of the four responses received from companies in the European top 500 strongly disagreed with the proposition that there is benefit in separation. Each of the other three companies strongly agreed that there is a benefit in separating these key roles.

Non-executive directors comprised more than one third of the board in all companies responding. Furthermore, in each company, the majority of non-executive directors were considered 'independent'. This is to be expected as the Combined Code recommends that non-executive directors

should comprise not less than one third of the board and the majority of them should be free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

### *Independence*

The most common tests used to determine directors' 'independence' are that such directors should not: represent a specific shareholder or other single interest group; participate in company share option or performance-related remuneration schemes; have conflicting or cross directorships; or have significant financial or personal ties to the company or its management which could interfere with the director's loyalty to shareholders.

Significantly, respondents did not generally consider serving as an employee of the company for more than five years to be a threat to independence. This contrasts with the United Kingdom where 64% of respondents considered directors not to be independent where they had been employees for more than five years (European average - 42%).

### *Stakeholder representation*

In some countries, directors represent specific stakeholder groups, for example in Germany, employees elect up to a half of supervisory board members. However, in the Republic of Ireland directors' duties are owed to the company, not directly to its shareholders, albeit directors must have regard for the interests of present and potential shareholders, and also the company's employees, creditors and other stakeholders. No respondents considered directors to represent any specific group other than the company itself.

### *Training*

The Combined Code recommends that directors should receive appropriate training on the first occasion that they are appointed to the board and subsequently where necessary, so it is no surprise that all the Irish respondents confirmed that directors receive appropriate training. However, across Europe as a whole, 53% of respondents did

not consider that each director received appropriate training when appointed to the board and subsequently where necessary.

### *Specialist committees*

#### *Audit committees*

All respondents had established audit committees prior to 1992. This compares with (say) France where only 80% of respondents had audit committees and of those, 79% were established after 1995. Across Europe as a whole, only 67% of respondents had audit committees.

In line with the Combined Code each respondents audit committees comprised at least three non-executive directors, the majority of whom are considered to be 'independent'. This contrasts with the European average where 17% of respondents have audit committees where executives exceed one third of the membership. In Switzerland, which has no code in this area, executive directors account for more than one third of audit committee members in 25% of those companies surveyed.

#### *Remuneration committees*

The Combined Code recommends that remuneration committees should consist exclusively of non-executive directors who are independent. All four respondents complied with the Combined Code in this respect. This contrasts with (say) France and Switzerland where the recommendations are not so tightly drawn and executive representation on remuneration committees is prevalent.

#### *Nomination committees*

In 1992, the Cadbury report recommended that companies establish nomination committees, but did not make this part of its Code of Best Practice. Nevertheless, in 1998, this recommendation was incorporated into the Combined Code with the proviso that such committees may not be appropriate for small boards. Furthermore, it was recommended that a majority of the committee members should be non-executive directors. Irish companies appear to have little difficulty in this area - all the respondents had

nomination committees, and in each case a majority of committee members were non-executive directors. Three out of the four respondents had nomination committees comprised solely of non-executive directors.

#### Internal control and risk management

Respondents generally agreed that their board was aware of the significant risks and opportunities facing their company, and that an effective system of internal control and risk management was in place. This is not surprising as such issues have been highlighted in recent years by the Turnbull report and its focus on the board's responsibility to review the effectiveness of systems of internal control.

All respondents considered that their system of internal control addressed all the specified categories of risk to a greater or lesser extent. However, emotional, environmental and reputational risks appear to be less well addressed than more 'traditional' risks such as those associated with products, processes and the market in which the company operates.

As in the United Kingdom, respondents generally agreed that they had identified the value each stakeholder requires and that systems were in place to measure the creation/destruction of shareholder value. However, respondents were less confident that the value required by other stakeholders had been identified and that systems were in place to measure the creation/destruction of value for them. This contrasts with the position elsewhere in Europe where a much higher proportion of respondents considered that systems were in place to measure value for stakeholders other than shareholders.

#### Internal and external audit

All the Irish respondents had an internal audit function which is to be expected as both the Combined Code and the Turnbull report give a strong steer in this direction. What is surprising, however, is that a number of respondents from elsewhere in Europe, particularly in France and Switzerland, do not have such a function. The obvious question is how do the boards of such companies gain assurance over the adequacy of their systems of internal control?

Consistent with responses from elsewhere in Europe, respondents did not generally appear to value the contribution of external auditors as much as that of their own internal audit function.

Communications between internal auditors and audit committees on the system of internal control, accounting policies and fraud is commonplace. Communications on business strategy and risks facing the business are surprisingly infrequent.

Respondents considered external auditors to be particularly communicative on issues surrounding the financial statements, accounting policies, the system of internal control and, perhaps surprisingly, fraud. Elsewhere in Europe, fraud was not an area in which communications with external auditors were considered particularly strong. In contrast to the United Kingdom, the four Irish respondents did not believe that auditors entered into a strong dialogue with the audit committee on social, ethical and environmental matters.

#### Disclosure

With respect to disclosures, it is encouraging that all the information published in the annual report and accounts is also available on the internet. Detailed information about strategy, known events and uncertainties that might affect future performance, systems of internal control and risk management is widely available. However, the survey suggests that disclosure of key relationships and disclosures on community ethical and social issues is less prevalent.

11

Italy

Corporate Governance  
in Europe

## Italy

### Corporate governance regime

In Italy, the economic landscape has not traditionally been characterised by large liquid capital markets - rather by a relatively small number of powerful industrial families with large shareholdings in listed companies. However, by the late 1990s the corporate governance scene had shifted. The market capitalisation of the Milan Stock Exchange had risen to nearly 50% of the GDP, and the new legislation introduced by the Consolidated Law on Financial Intermediation (the Draghi law) and the related implementing regulations had gone some way to bringing conditions into line with those prevailing in other countries with highly developed financial systems. Furthermore, the financial market had become substantially international with overseas investors accounting for some 40% of trading.

Notwithstanding all the changes introduced in the 1990's, it was recognised that success in competing for access to the financial markets and minimising the cost of capital depends to a large part on the efficiency and reliability of a company's system of corporate governance. Furthermore, it was accepted that, in an increasingly competitive environment, Italian companies must continuously benchmark their standards of corporate behaviour against those companies operating in the most advanced economies.

#### The basic framework

In the late 1990s, the Draghi Commission was set up by the government to report on the state of corporate governance in Italy. Its proposals, which primarily addressed cross ownership and the general structure of Italian companies, were incorporated into law (with some modification) as part of Italy's unified body of law (the 'Testo Unico'). This came into force on 24 February 1998. The new law laid the foundations for a corporate governance model in tune with those countries with more highly developed capital markets. It also introduced important reforms in terms of the responsibility of company management and supervision of the control system. However, the law makers were heedful of certain practices such as:

- the unitary board structure;

- the requirement to have a 'board of auditors' as a control body; and

- the limited board presence of managers.

#### Recommendations and codes

In 1999 the Committee for the Corporate Governance of Listed Companies (the Preda Committee) issued a Code of Conduct which provides important guidelines on the composition and roles of the governing bodies and the governance structure.

The Code is aimed at making Italian companies more competitive within the world of financial and industrial globalisation. In particular, it provides a reference model for company management which is in line with international standards but at the same time in compliance with specific Italian practices. Roughly based on the Cadbury report in the United Kingdom and the Viénot report in France, the Preda Code addresses the proper control of company risks, the creation of a suitable proxy system, transparency, and most importantly, the maximisation of shareholder value.

Compliance with the 13 principles of the Preda Code is voluntary for Italian listed companies.

#### Directors

The basic tenant is that listed companies be governed by a board of directors that meet at regular intervals and adopt an organisation and *modus operandi* that enable it to perform its functions effectively and efficiently. The duties of the board include:

- the approval of the company's strategic, operational and financial plans and the corporate structure of the group it heads;
- the delegation of powers to the managing directors and the executive committee;
- the determination of directors' remuneration (after considering the recommendations of the remuneration committee);

- the supervision of the performance of the company, including conflicts of interest;
- the examination and approval of significant transactions (including those involving related parties); and
- reporting to shareholders at shareholders' meetings.

The Preda Code recommends that the board shall be made up of executive and non-executive directors. The number of non-executive directors shall be such that their views carry significant weight in board decisions. In line with international practice, an appropriate number of the non-executive directors should be independent, in the sense that their judgement is not influenced by business relationships with the company nor by significant shareholdings in the company.

#### *Chairman and chief executive officer*

The chairman is responsible for the running of the board, the distribution of information to directors and the coordination of the boards activities. It is not unusual for management powers to be delegated to the chairman, either alone, or together with other managing directors. Consequently, the Preda Code does not recommend the separation of the roles of chairman and chief executive officer. However, listed companies should make clear the division of responsibilities and disclose in their annual report adequate information on the powers delegated to the chairman.

#### *Appointment*

There should be a transparent procedure for the appointment of directors. Proposals for appointment should be accompanied by detailed information on the abilities and professional qualifications of the candidates.

Nomination committees are encouraged (especially for companies with a broad shareholder base). Where a nomination committee is established, the majority of its members should be non-executive directors.

#### *Directors' remuneration*

The Preda Code recommends that, to ensure no director can influence the determination of their own remuneration, boards should set up remuneration committees to make recommendations to the board on the remuneration of executive directors. However, the ultimate authority to determine directors' remuneration rests with the board. A majority of remuneration committee members should be non-executive directors.

As a general rule, part of executive directors' remuneration should be linked to a company's profitability and the achievement of specific pre-determined objectives.

#### *Shareholders*

The Code recommends that chairmen and managing directors actively endeavour to create a dialogue with individual shareholders and institutional investors, and that companies identify an individual to manage such relations.

It is recognised that shareholders' meetings are an integral part of the relationship between the board and shareholders. Consequently, the Code recommends that shareholder participation at meetings should be encouraged and that whenever possible all directors should attend. It is also recommended that companies should establish, with shareholders' approval, rules to ensure the orderly and effective conduct of shareholder meetings.

#### *Accountability and audit*

Under the Preda Code, managing directors are responsible for ensuring the effectiveness and adequacy of the internal control system. They should appoint one or more persons to run it. Such persons must not depend hierarchically on any person in charge of operative areas, but must refer their actions to the delegated directors, the internal control committee (see below) and the auditors.

Listed companies should establish an internal control committee made up of an appropriate number of non-

executive directors. (The chairman of the board of auditors and the managing directors may participate in the committee's meetings.) The internal control committee is responsible for:

- assessing the adequacy of the internal control system;
- assessing the work programme prepared by those responsible for internal control and receiving their periodic reports;
- maintaining relationships with auditors and reviewing the scope and results of the audit;
- reporting to the board of directors on its activity and the adequacy of the internal control system at least once every six months (ie, when annual and interim accounts are approved); and
- performing any other duties entrusted to it by the board of directors.

In addition to the above, the Draghi law requires that companies establish a board of auditors comprised of at least three individuals, all of which are independent from the company's directors and employees. The duties of the board of auditors include reviewing the adequacy of the company's organisational structure, the internal control system and administrative and accounting system. It should also review the reliability of the accounting system in correctly representing the company's transactions.

Members of the board of auditors must fulfil experience and integrity requirements laid down by the Minister of Justice. The Preda Code states that members should be elected by means of a transparent procedure. Shareholders should receive the information necessary in order to exercise their voting rights in an informed manner. Members of this board should act autonomously with respect to shareholders, including those that elected them.

12

Netherlands

Corporate Governance  
in Europe

## Netherlands

### Corporate governance regime

Corporate governance has been debated in the Netherlands for many years, however, the term 'corporate governance' is relatively new to the commercial and legal world. The key issues from a Dutch perspective are management supervision; transparency of management decisions and remuneration; the extent of worker participation; the transparency of and the accountability for the preparation and adoption of the annual account; and the level of regulation regarding public bids and hostile takeovers.

#### Historical background and recent developments

Dutch corporate law has adopted a unique two-tier board structure whereby a works council is given indirect involvement in the appointment of supervisory board members. This can be contrasted with the German approach which requires that a certain number of supervisory directors be elected directly by the workforce.

Until about 1986 the prevailing view in the Netherlands was that hostile takeovers could not happen. Virtually all companies listed on the Amsterdam Stock Exchange incorporated defensive measures into their articles of association. These measures can be used to prevent successful takeover bids without the consent and cooperation of the management and supervisory boards. The Dutch legal system allows for defensive measures that substantially dilute the power and authority of the general meeting of shareholders. Examples of this are priority shares and the unique corporate structural regime (see below). Other provisions incorporated into many companies' articles of association include mechanisms for creating privileged groups of shareholders. This is achieved through non-voting depositary receipts of shares and preference shares.

Over time, it has become generally accepted that this practice lacked legitimacy. In November 1997 a bill was presented to parliament proposing changes that would facilitate hostile takeovers.

Earlier in 1997 the Peters Commission presented its Report on Corporate Governance which has led to a number of

legislative proposals. The general trend is towards increasing shareholders' rights and transparency. Recent trends also emphasise the importance of environmental sustainability and social issues.

#### The basic framework

Under Dutch corporate law, large companies (those fulfilling certain size criteria) are subject to the so called 'structural regime'. Other companies fall within the normal regime.

The key difference between a company falling within the normal regime and one falling within the structural regime is that is that under the structural regime certain powers usually reserved for the meeting of shareholders are transferred to the board of supervisory directors.

#### Recommendations and codes

In 1997 the Peters Commission presented its Report on Corporate Governance. The commission made 40 recommendations. The first 25 recommendations emphasise transparency and the responsibilities of the board. Recommendations 26 to 33 concern the influence of shareholders and the general meeting of shareholders. The remaining recommendations concern various other subjects such as disclosure of the key corporate governance principles, the role of external auditors and compliance monitoring.

In 1998 a new report appeared, *Monitoring Corporate Governance in the Netherlands*. This report addressed the extent to which the Peters recommendations had influenced corporate governance. It was concluded that while the recommendations concerning the supervisory and managing boards were followed, the recommendations concerning the influence of the shareholders had been less successful.

In January 2001 the Dutch Social Economic Council (an independent advisory body) proposed that the powers of the supervisory board be somewhat diluted for the benefit of the general meeting of shareholders. In addition it is recommended that holders of non-voting depositary receipts

of shares (about one third of Dutch listed companies trade non-voting depositary receipts rather than voting shares) have voting rights in certain circumstances. It is likely that the structural regime will be amended accordingly, and that the advice will have an anticipatory effect, causing supervisory boards to cautiously exercise their rights in cases of conflict or dispute with shareholders.

### Management bodies

Companies incorporated under Dutch law have two tier boards - the management board and the supervisory board.

#### *The normal regime*

The management board is charged with the management of the company. The supervisory board is charged with the supervision of the management board and provides advice on many matters including strategy.

Supervisory boards are not a legal obligation under the normal regime. If the articles of association provide for a supervisory board, the board members are appointed by the general meeting of shareholders. The general meeting of shareholders has also the power to remove a board member.

The supervisory board is empowered to suspend any director at any time, unless the articles of association provide otherwise. Furthermore, the supervisory board is empowered to represent the company in all matters in which the company has a conflict of interest with one or more directors.

#### *The structural regime*

Both management and supervisory boards in a large company have the same role as in a company falling within the normal regime. However, the supervisory board has greater powers under the structural regime such as the power to appoint and remove directors and the power to adopt the annual accounts. Furthermore, some important management decisions are subject to prior approval of the supervisory board.

New members of the supervisory board are appointed by the supervisory board itself. Under certain circumstances the general meeting of shareholders can object to the intended appointment. A member of the supervisory board shall resign no later than four years after his appointment. Upon application, the Enterprises Chamber of the Amsterdam Court of Appeal may remove a supervisory board member for dereliction of his duties, for other important material reasons, or on account of any far reaching change of circumstances, as a result of which the company may not reasonably be required to maintain him as a supervisory board member. Such an application may be made by the company, represented for this purpose by the supervisory board or by the general meeting of shareholders or by the works council.

### Directors' remuneration

Directors' remuneration is the subject of a legislative proposal to require members of both the management and supervisory boards to disclose their individual remuneration (including salary, pension contributions, profit-sharing rights and share options) in the annual report. It is proposed that members of the management board and supervisory board also report their shareholding in the company to the STE (the supervising authority in the field of securities trade in the Netherlands).

### Shareholders

In 1997 a bill aiming to facilitate hostile takeovers was presented to the Dutch parliament. In essence, a shareholder who has acquired over 12 months at least 70% of the capital of a listed company, may petition the Enterprise Chamber of the Amsterdam Court of Appeal to set aside the defensive measures employed by the target company. Such a petition will generally be granted unless the target company can demonstrate that the exercise of control by the majority shareholder is against the interests of the company. At this stage it is uncertain whether and to what extent the bill will be adopted by parliament, but it is expected to have an anticipatory effect.

### Accountability and audit

There is an increasing trend in The Netherlands towards the use of International Accounting Standards, which it is hoped will enhance the amount of corporate transparency. Legislative proposals support this possibility, as well as the adoption of US GAAP.

### Directors' liability

In 2001 the Dutch parliament adopted a bill dealing with the accountability of directors for their company's policies. A distinction is made between resolutions in the general meeting of shareholders to adopt annual accounts and the acquittal granted to members of the management and the supervisory boards. Acquittal should be a separate resolution at the general meeting of shareholders.

### Corporate governance survey

Questionnaires were sent to the chairman of the supervisory board of all 210 companies listed on the Amsterdam Stock Exchange (AEX). A total of 32 questionnaires (15%) were returned. Of the 23 Dutch companies falling within the top 500 European companies (by market capitalisation), 6 companies responded to our questionnaire.

Of the 32 responses, 11 were from companies which were also listed on foreign stock markets (New York, London, Frankfurt and Tokyo). The average market capitalisation was EUR 7.2 million although the maximum market capitalisation amounted several EUR billions. Institutional shareholders hold on average 56% of the shares.

The main activities of the responding companies are diverse and comprise amongst others automotive, financial services, industrial products production and wholesale, ICT and consulting services, electronics, energy, construction and food activities.

### Board structure

The survey results underline the benefits of separating the roles of the chairman of the supervisory board and the chief executive officer (a management board member).

The survey found that the average composition of boards and board committees in the Netherlands is as follows:

- Management board - 3 directors
- Supervisory board - 6 directors
- Audit committee - 3 to 4 directors
- Remuneration committee - 3 directors
- Nomination committee - 3 directors

### Independence

In general, the independence of supervisory board members is perceived as an important qualification. Virtually all companies determine independence as being independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment. The most important independence tests applied in Dutch companies are in line with other European countries. The most commonly applied independence tests are the assessment of: conflicting or cross directorships (94%); significant financial or personal ties (94%); and the receipt of income from the company other than supervisory board member fees (94%).

The perceived threat to independence of participation in the company's share option or performance related remuneration scheme is much greater in the Netherlands (81%) and the United Kingdom (93%) than for Belgium, Germany and Switzerland.

### Meetings

The two-tier regime in the Netherlands explains the large number of management board meetings. The supervisory board meets on average 6 times per year. The survey found that, on average:

- The management board met, on average, 25 times during the year. Each meeting lasted approximately 3 hours and the average number of members attending was 4.
- The supervisory board met, on average, 6 times during the year. Each meeting lasted approximately 3 hours and the average number of members attending was 7.

- The audit committee met, on average, 3 times during the year. Each meeting lasted approximately 2 hours and the average number of members attending was 3.
- The remuneration committee met, on average, 2 times during the year. Each meeting lasted approximately 1 hour and the average number of members attending was 3.
- The nomination committee met, on average, 3 times during the year. Each meeting lasted approximately 2 hours and the average number of members attending was 3.
- The executive committee met, on average, 20 times during the year. Each meeting lasted approximately 3 hours and the average number of members attending was 5.

In the Netherlands, both management boards and supervisory boards have a wider range of skills than many other European countries. In particular, directors experienced in marketing and sales are well represented in the Netherlands.

#### *Directors' experience*

Board members with experience of working in other European countries are present in approximately 40% of respondents, followed by North American and UK experience (approximately 25%). In other countries non-executive directors tend to have more international experience than their executive counterparts, however, this is not the case in the Netherlands where both executive and non-executive directors appear equally experienced.

Directors' experience

	Finance	Marketing/ Sales	Manufacturing	Technology	Other
<b>Managementboard/ executive directors:</b>					
Netherlands	88%	94%	69%	59%	22%
Europe	79%	69%	59%	43%	15%
<b>Supervisory board/ non-executive directors:</b>					
Netherlands	94%	88%	72%	59%	47%
Europe	83%	67%	63%	50%	34%

### *Directors' age profile*

As can be expected, the average age of supervisory boards is higher than the average age of management boards. The age of management board members lies between 40 and 50 years (30%), and between 50 and 60 years (60%). The age of supervisory board members lies between 50 and 60 years (47%), and between 60 and 70 years (44%).

### *Stakeholder representation and communication*

As a consequence of the Dutch 'structural regime' stakeholder representation within the supervisory board has not been developed. However one third of all companies report that major stakeholders are represented on the supervisory board. A lower portion of companies confirms the presence of management board members representing major shareholders. The only other stakeholder participation, although a very small proportion, is from employees.

### *Directors' appointment criteria*

Public disclosure of the competence profiles of supervisory board members (81%) is much higher compared with disclosure of competence profiles of management board members (38%). From a qualitative analysis of the directors' appointment criteria we learn that competence profiles and complementary competences are by far the most important criterion for appointment. Interestingly the behavioural skills such as change management capabilities, team player, people management and social skills are more important appointment criteria for management boards. Whereas international experience is a more important appointment criterion for supervisory boards.

### *Board evaluation*

A majority of respondents confirm the existence of a process for the regular evaluation of the audit committee (65%). Although 94% of the supervisory board members evaluate the performance of the management board, only 58% of them evaluate the performance of the chairman.

In line with Europe as a whole, though lower than in the United Kingdom (89%), half of all directors received appropriate training after their appointment to the board.

### *Audit committees*

In 1987 only one respondent had established an audit committee. However, by 2001, 53% of respondents had established an audit committee. Of these, the majority (70%) had adopted a formal written charter setting out the committee's responsibilities - this is in line with the average position across Europe (67%).

Dutch audit committees meet between one and six times a year and on average 2.7 times a year. Generally audit committee meetings last for approximately two hours. It is interesting to observe that most audit committees meet more than 5 days prior to accounts closure (68% compared to 59% for other European companies). However, in line with the European average, 18% of respondents audit committees met only one day prior to accounts closure.

Management board directors are present at approximately 80% of audit committee meetings. The attendance of external auditors is more common than that of internal auditors' though not all respondents had an internal audit function.

More than 80% of audit committee meetings consider the following subjects:

- Adequacy of internal control and risk management systems.
- Quality of the companies accounting policies, judgments and disclosure.
- Interim financial statements and the quality of the process to prepare them.
- Year-end preliminary announcements.
- Consideration of the independence and proposed scope of the external auditors work.

### Internal control and risk management

In line with the results in other countries, many respondents agreed that their board is fully aware of the significant risks faced by the company, and that an effective system of internal control and risk management is in place. The management board is most involved in regular reviews of the system of internal control and risk management, followed by the audit committee and then the supervisory board.

The tools used by directors for identifying, assessing and monitoring risks include regular planning and control methods. Examples include predefined ratios, KPI's, ad hoc assessments and business risk self assessment workshops.

Internal control systems are generally more focused on risks directly relating to the organisations reputation. Risks relating to intellectual capital and emotional capital (eg, staff retention) are covered much less.

While the respondents largely confirm that major stakeholders have been identified, the systems in place are focused predominantly on measuring creation and/or destruction of shareholder value. Value management for other stakeholders is not so well developed. The key performance measures used are economic value added and return on investment/capital employed/sales. Qualitative and non-financial criteria are rarely applied.

### Internal and external audit

A majority of the responding companies have an internal audit function for which 63% adhere to the Institute of Internal Auditors' standards or similar standards. The internal audit function reports directly to the chief executive officer (CEO) in 59% of the companies, to the chief financial officer (CFO) in 23% of the companies. In the remaining companies internal audit reports to the CEO and CFO jointly.

External audit appears to be more respected than internal audit and more often serves more as a sounding board for directors. Conversely, internal audit is seen as a more value

adding resource and is perceived to be more business objective oriented. Both internal and external audit are not generally seen as a training ground for senior management.

Generally both external and internal auditors are seen as communicating equally well with the audit committee. The exceptions are the system of internal control and risk management; accounting policies; the financial statements (which are more in the domain of external auditors); and social and environmental issues (which are more in the domain of internal auditors).

### Disclosure

On average, less information is disclosed via the internet than in the hard copy annual report and accounts. However, it is encouraging that certain information is widely reported on the internet. This includes the organisation's purpose, strategy, principal drivers of performance, and policies and performance on community, social, ethical and reputational issues.

Matters concerning the organisation's system of internal control and risk management are not widely reported in the annual report (51%). Internet disclosure is significantly lower (29%).



13

Switzerland

# ESG

Corporate Governance  
in Europe

## Switzerland

### Corporate governance regime

Corporate governance is not defined under Swiss law, although the topic is not new and has been widely discussed in legal literature in recent years. Two key themes emerge.

First, corporate governance deals with the structure of a company's executive positions and focuses on the balance between different bodies within a company's so-called inner circle. The inner circle is understood to include the company's management (those responsible for the operational running of the company); the board of directors; and external auditors. Second, corporate governance concerns the relationship among those who run the company, those who own the company (investors) and any third party with a relationship with the company (for example, stakeholders, creditors and supervisory authorities).

In a broader sense, corporate governance may be described as a set of principles aimed at serving shareholders' interests. It covers provisions about shareholder information and participation rights; the duties and organisation of the board of directors; the management; the auditing bodies and the system of checks and balances.

In 2001, Swiss commentators have focused on audit committees and the development of best practice provisions. One reason for this interest is that some publicly listed companies have experienced corporate mishaps, if not corporate failures, in the first half of 2001. Also, a group of federal parliamentarians recently ordered the Federal Government to investigate whether the current Swiss Code of Obligations (CO) still represents the necessary benchmark for good corporate governance. It appears that a privately initiated solution would have been favoured by influential circles. Another important development is that Swiss companies are increasingly seeking listings outside of Switzerland, particularly on the London and New York stock exchanges. Since these companies comply with the stringent corporate governance standards required by such exchanges, it is logical and understandable that shareholders of companies with only a sole listing at the SWX Swiss Exchange should benefit from equivalent standards.

### The current framework

Switzerland currently does not have a specific code dealing with corporate governance issues and unlike many other European countries, no best practice rules have been established to date. However, this does not mean that corporate governance related regulations are non-existent. Terms and conditions applying to corporate governance are found in the CO, the Swiss Federal Law on Stock Exchanges and Trading in Securities (SESTL), and the Swiss Law on Banks and Saving Banks (BankL). Additionally, case law and other regulatory guidance (most notably that produced by the Swiss Federal Banking Commission and the Federal Office of Private Insurance) may impact on areas of corporate governance. Finally, a company's Articles of Incorporation, its organisational guidelines and regulations, also influence the basic principles of corporate governance.

### Board of Directors

The board of directors may take decisions on all matters that by law or the Articles of Incorporation are not allocated to the shareholders' meeting. The board shall manage the business of the company insofar as it has not been delegated to management (Art. 716 CO). However, the board of directors has certain non-transferable and inalienable duties which include: the ultimate management of the company; the system of financial controls; and the preparation of the annual report and accounts.

As a general rule, the board of directors delegates daily management to individual members or third parties (Art. 716b CO). Delegation of management must be authorised in the company's Articles of Incorporation and precisely defined in organisation regulations to be issued by the board of directors.

Contrary to the legal framework as established in the CO, it is mandatory under the BankL that the management of a bank is delegated by the board to management (Art. 3 paragraph. 2(a) BankL). Furthermore, the same person may not belong to both the board of directors and management (Art. 8 paragraph. 2 of the implementing ordinance of the BankL).

### *Directors' remuneration*

There are no comprehensive legal provisions dealing explicitly with board compensation. The board determines the remuneration of its members as well as management. Incentive structures that depend on the success of a business enterprise are permissible and are common in practice.

Under Swiss law, there are no existing regulations calling for the publication or disclosure to shareholders of the remuneration paid to the members of the board of directors and management.

### *Shareholders*

According to Art. 698 CO, the shareholders meeting is the supreme corporate body of a stock corporation. Its inalienable powers include the adoption and amendment of the Articles of Incorporation; the election of board members and auditors; approval of the annual report and accounts; and the dismissal of board members.

The shareholders' meeting is called by the board of directors or, if necessary, by the auditors. Alternatively, one or more shareholders representing together at least 10% of the share capital may also request a shareholders' meeting. Those shareholders representing shares having a par value of one million Swiss Francs or at least 10% of the share capital may request items to be included in the agenda (Art. 699 CO).

The shareholders' meeting is called at least 20 days prior to the day of the meeting (Art. 700 CO). The request for a meeting must include the agenda items and the motions of the board of directors and shareholders. Following a circular of the SWX Stock Exchange, publicly listed companies are obliged to inform the SWX Swiss Exchange about the date of their next annual shareholders' meeting at least three months in advance.

Shareholders exercise their rights at the shareholders' meeting. Since it would contradict the 'principle of directness', circular resolutions or internet voting are not accepted under Swiss law. Such resolutions are therefore null and void. Shareholders may represent their shares at

the shareholders' meeting personally or may have them represented by a proxy, that is a third person who need not be a shareholder unless otherwise provided for by the Articles of Incorporation (Art. 689 CO).

### *The planned framework*

In Autumn 2001, a multi-disciplinary committee under leadership of the Swiss Business Federation (economiesuisse) published a draft Code of Best Practice (the Swiss Code). In parallel to this, the SWX Swiss Exchange published a draft set of guidelines regarding the corporate governance of listed companies (the Guideline). While the Swiss Code contains recommendations, the Guideline is quas-binding. The interaction between the two proposals are such that they may be considered a single regulatory framework. It is anticipated that this new regulatory framework will enter into force by mid 2002.

### *The Guideline*

The purpose of the Guideline is to provide investors with certain additional key information about the governance of listed companies. The Guideline sets minimal standards concerning disclosure of a company's internal organisation and its relationship with shareholders. Disclosure of information with regard to other parties (ie, stakeholders other than shareholders) is not covered by the Guideline.

The Guideline will apply to all companies with a primary listing on the SWX Swiss Exchange irrespective of the law under which the company has been incorporated.

The information to be disclosed is listed in an attachment to the Guideline. The exclusion of any relevant information must be justified.

The key elements of disclosure include information about: the group structure and shareholders; the board of directors and management (including details of their remuneration and participation in the share capital); information on shareholders' participation rights; the policy with regard to dividend payments; and details of the company's policy on changes of control and defence tactics.

### *Swiss Code of Best Practice*

The Swiss Code will only apply to publicly listed companies. However, most of the Code's 30 recommendations are also relevant to large unlisted companies. The Swiss Code is meant to be construed as a set of recommendations rather than as a regulatory straight jacket.

Although other best practice codes and the Organisation for Economic Cooperation and Development's report on corporate governance served as a starting-point, the Swiss Code was established in light of the specific corporate situation in Switzerland with its diversity of big, middle-sized and small stock corporations.

The Swiss Code will complete the existing legal framework on stock corporations. Its main objective is improving shareholders' rights. The recommendations primarily establish standards with regard to shareholders' rights before, during and after the shareholders' meeting. Further topics are duties of the board of directors; its composition and organisation; its handling of conflicts of interests; its committees; and internal control and the management of risks.

## Corporate governance survey

### The board

The survey suggests that more than 80% of the boards of Swiss companies consist of ten or fewer members. This indicates that Swiss boards are generally smaller than many of their European counterparts.

The following is an analysis of board size in Switzerland and Europe:

- 1 to 6 members - Switzerland 37%, Europe 17%
- 7 to 10 members - Switzerland 51%, Europe 38%
- 11 to 14 members - Switzerland 10%, Europe 30%
- 15 to 18 members - Switzerland 2%, Europe 5%
- More than 18 - Switzerland 0%, Europe 10%

The effectiveness of boards can be affected not only by the size of the board, but also by the composition of the board ie, the ratio between executive and non-executive members.

### *Segregation between board of directors and executive management*

In principle, a distinction can be made between unitary and two-tier board models. In unitary boards, the responsibility for management and control is handled by one single body, whereas in two-tier boards, the management and control functions are separated. Swiss companies have unitary boards.

In Switzerland, the functions of board chairman and chief executive officer are frequently performed by the same person. Many respondents (53%), however, considered that segregation of the two positions is extremely important, whereas 28% of respondents consider such segregation to be an important advantage. Segregation is generally considered advisable as it helps prevent an unhealthy accumulation of power in one individual. Nevertheless, there are also positive aspects of combining the duties of chairman and chief executive officer in a single person. Know-how, sector knowledge or a shortage of qualified management may mean that it is advisable for both functions to be carried out by a single person.

### *Meetings of the Board of Directors*

Switzerland is in line with the European average with around six board meetings per annum. By way of comparison, executive meetings are much more frequent (on average 22 per annum).

On average, board meetings in Switzerland last for more than five hours. The European average is lower - for example, nearly 60% of board meetings in France last between two and three hours whereas in the United Kingdom, the average figure is around three to four hours.

### *International experience of directors*

In the global economy, international experience is extremely important. More than 55% of boards have at least one

executive director with international professional experience of more than two years within Europe or North America, whereas around 38% can point to some form of practical experience in Asia. Non-executive directors members are able to point to more extensive international experience than their executive counterparts - 71% of boards have non-executive directors with professional experience in North America, 57% elsewhere in Europe and 40% in Asia.

In general, the international experience of Swiss executive directors is slightly higher than the European average.

#### *Specialist experience of directors*

The specialist experience of executive and non-executive directors is set out below in the following categories - finance, marketing, production, research and development and other.

- 88% of non-executive directors and 83% of executive directors have finance experience (Europe 79%).
- 82% of non-executive directors and 75% of executive directors have marketing experience (Europe 69%).
- 68% of non-executive directors and 65% of executive directors have production experience (Europe 59%).
- 65% of non-executive directors and 55% of executive directors have research and development experience (Europe 43%).
- 32% of non-executive directors and 17% of executive directors have experience in other areas (Europe 15%).

#### *Age of directors*

Experience and knowledge with regard to markets and sectors have an important role to play with regard to the composition of corporate boards - age is of less significance in this respect. However, a review of the the ages of senior executives and board members demonstrates that executive directors (on average 48 years old) are approximately seven years younger than non-executive board members.

#### *Evaluation*

Quality controls are advantageous for ensuring permanent improvement in the performance of directors and also the performance at the lower hierarchy levels at the company. Executive directors are frequently assessed by the non-executive directors. However, it is rare for the non-executive directors and board sub-committees to be evaluated.

A process for assessing non-executive directors has been carried out at only 19% of respondent companies, where as a process for assessing the audit committee is encountered in only 22% of companies. By contrast, the assessment of executive directors has been carried out by 83% of respondents.

#### *Specialist committees*

##### *Audit committee*

The survey shows that around 62% of respondents had set up audit committees. On average, the audit committee consists of three members who are, in general, non-executive directors. Only 30% of audit committee members are also involved in an executive function. The audit committee meets on average around three times per annum, and each meeting lasts an average of between three and four hours.

The survey has confirmed that the main tasks of the audit committee consist of quality assurance with regard to accounting principles, their implementation and their disclosure. A great deal of emphasis is also devoted to ensuring the appropriateness of internal control and risk management systems in addition to compliance with relevant legislation and regulations.

##### *Remuneration and nomination committee*

The main task of the remuneration committee is to assess matters with regard to directors' remuneration. The survey shows that 48% of companies in Switzerland currently have a remuneration committee. Generally, one third of remuneration committee members are executive directors and two thirds of the members are non-executive directors. Meetings are held around three times every year, although

they are usually of a shorter duration than audit committee meetings (ie, average of two to three hours).

The nomination committee deals primarily with aspects of personnel planning and recruiting directors. Only 22% of respondents had set up nomination committees. Where such committees exist, their composition and the number and duration of meetings is comparable to the remuneration committee.

### Internal control and risk management

The core responsibilities of the board not only includes the fundamental strategic direction of the company but also the assessment of the opportunities and risks facing the company. The survey illustrates that, in Switzerland, the board is more adept at perceiving risks than opportunities. Less emphasis is placed on the control and risk management system than in many other countries.

On the question of the nature and quality of internal control and the risk management system, most of the respondents believed that their system is focused on the vision and corporate objectives, and is embedded in the organisation. Systems are regularly reviewed by the audit committee and executive directors. Around 62% of respondents feel that this system generates added value.

The survey addressed the category of risk covered by the internal control system. Market environment, products and processes and reputation risks are expected to be covered by almost 70% of respondents systems. The other risks such as research and development, environment protection, intellectual property, health and security, and staff satisfaction are covered by between 40% to 60% of respondents systems.

### Disclosure

Swiss companies are under no obligation to disclose individual board compensation packages, the number of company shares held and information on other board positions. Disclosure is ultimately at the discretion of the chairman. Nevertheless, disclosure levels have improved in

recent years, particularly in relation to directors' tenure and main executive position. This enables a clearer assessment of independence to be made.

In general, more corporate information is available via the annual report than via company web sites. Information about strategic objectives and key success factors is frequently published (92% and 95% of respondents respectively). However, few companies have disclosed information about their system of internal controls and risk management (33%), environmental issues (36%), and ethical, social and reputational concerns (39%).

14

United Kingdom

## United Kingdom

### Corporate governance regime

In the United Kingdom, corporate governance is characterised by large liquid capital markets, a growing concentration of power within institutional investors, and an active takeover market. Unlike many other European countries, banks, powerful families, employees, and governments do not generally play as significant part in the governance of companies as shareholders.

In the classical public company model, shareholders elect directors, who manage the company on their behalf and report back on their stewardship at shareholder meetings, at which they can either be re-elected as directors or dismissed. Unfortunately there is a gap between this model and reality - the interests of shareholders and (executive) directors can diverge on issues such as directors' remuneration, takeover bids MBOs and appointments within the organisation.

The key aim of business is to enhance shareholder value over the long-term. Of course, the way in which companies are governed should have regard to the interests of all stakeholders, but it is the primacy of shareholders that is paramount. However, shareholder value can be maximised only through directors having regard to the other relationships on which the company depends - such as those with employees, customers, suppliers and the community, as well as to the impact of business decisions on the company's reputation and the environment. There have been concerns in recent times that the pendulum has swung towards short-termism and directors have neglected long-term prosperity in favour of a quick profit. For this reason, Company Law Reform is seeking to re-establish the equilibrium and ensure that both short and long term views are evaluated in determining company success.

Historically, the United Kingdom has adopted a unitary board comprising both executive and non-executive directors. The chairman is usually, but not always, a non-executive director. Executive and non-executive directors have different functions within the company, but the same responsibilities under the law. However, despite this separation of functions, formal two tier board structures have not been developed in the United Kingdom.

The responsibilities of the board include setting strategic objectives, supervising management and reporting to shareholders on its stewardship. Non-executive directors contribute to the formulation of strategy and often fulfil a specific supervisory function through membership of audit and remuneration committees.

#### The basic framework

Shareholders elect directors, who manage the company on their behalf and report back on their stewardship at shareholder meetings. While the law requires directors to have regard to the interests of employees and to those who have contracts with the company, there is no requirement for any specific group (eg, employees) to be represented on the board.

The basic legal duties of directors fall into three categories: a duty to exercise care and skill, fiduciary duties, and statutory duties. These duties are common to all directors and are owed to the company, meaning generally the shareholders collectively, both present and future, not the shareholders at a given point in time.

The duty to exercise care and skill is rather vague as there are no recognised standards of the degree of care and skill required. Nevertheless, the Courts would expect an experienced director to demonstrate a higher level of skill than a less experienced director.

Fiduciary duties are more strict than the duty to exercise care and skill. They include a duty to act in good faith, a duty not to act for improper purposes, and a duty not to engage in corporate opportunities.

Statutory duties include the appointment and removal of directors, strict and well defined categories of what directors must not do, the appointment of auditors, disclosure of directors' interests and remuneration, annual reporting requirements, and the conduct of annual general meetings.

At the time of writing, there are proposals to modernise company law. In particular, a statutory statement of directors' duties is proposed.

In addition to the legal framework, the United Kingdom governance regime includes various governance codes and regulatory requirements. The principle amongst these are the Listing Rules of the UK Listing Authority and the Combined Code appended to those rules.

### Recommendations and codes

The publication of several influential reports in the 1990's raised the profile of corporate governance and caused some significant changes to the governance framework.

- Cadbury (1992) - Helped raise standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly the respective responsibilities of those involved. The Committee recommended inter alia, that boards report on the effectiveness of systems of internal control.
- Rutteman (1994) - Provided guidance to directors on internal control and concluded that directors should limit their review to internal financial controls and report only that they have carried out such a review (ie, not report whether or not controls are effective).
- Greenbury (1995) - Spurred on concerns about large pay increases and gains on exercise of share options in recently privatised utility industries, the Greenbury Committee recommended extensive disclosure of directors' remuneration and set guidelines for determining executive pay.
- Hampel (1998) - Developed from the earlier reports, Hampel recommended that directors maintain and review controls in general and not merely financial controls; and companies that do not have an internal audit function should from time to time review the need for one.

Following the work of the Hampel Committee, in June 1998 the UK Listing Authority published a new Listing Rule together with related Principles of Good Governance and Code of Best Practice (the Combined Code). The Committee's basic premise was that the principles of

corporate governance should be applied flexibly, with common sense and due regard to companies' individual circumstances, and that the annual report should explain the application of the principles.

The Combined Code contains 14 corporate governance principles and 45 provisions applicable to all listed companies incorporated in the United Kingdom. The Combined Code is appended to, but does not form part of, the Listing Rules. However, the Listing Rules do require listed companies to include in their annual report and accounts a narrative statement explaining how the principles have been applied (the principles statement) together with a statement setting out the extent of compliance with the detailed provisions and reasons for any non-compliance (the compliance statement). A company's external auditors are required to review such compliance statements before publication, but only in so far as it relates to seven of the 45 Code provisions.

### Directors

A basic tenant of corporate governance is that every company should be headed by an effective board which should lead and control the company. The Combined Code goes on to recommend: that boards should have a formal schedule of matters specifically reserved to it for decision; that all directors should bring an independent judgement to bear on issues of strategy, performance, resources and standards of conduct; and that every director should receive appropriate training when appointed to the board and subsequently as necessary.

### Board balance

Boards comprise both executive and non-executive directors though the basic legal duties are common to both. The Code recommends that non-executive directors should comprise not less than one third of the board and the majority of them should be free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

Executive directors share with their non-executive

colleagues overall responsibility for the leadership and control of the company. As well as speaking for the business area or function for which they are directly responsible, they should exercise individual judgement on every issue coming before the board, in the overall interests of the company. In particular, an executive director other than the chief executive officer needs to be able to express views to the board which are different from those of the chief executive officer and be confident that, provided that this is done in a considered way, the individual will not suffer. Boards should only appoint as directors executives whom they judge to be able to contribute in these ways.

Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy, however, they also have a control or monitoring function too. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives.

The chairman is usually, but not always, a non-executive director. Where the posts of chairman (responsible for the running of the board) and chief executive officer (responsible for the running of the company's business) are combined in one person, the decision to do so must be publicly justified. In any event, there should be a strong and independent non-executive element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed. The chairman, chief executive and senior independent director should be identified in the annual report.

#### *Appointment and service contracts*

The Combined Code advocates a formal and transparent procedure for the appointment of new directors to the board and that all directors should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. Non-executive directors should be appointed for specified terms subject to re-election and to company law

provisions relating to the removal of directors. Reappointment should not be automatic.

The Code goes on to say that there is a strong case for setting notice or contract periods at, or reducing them to, one year or less. Boards should set this as an objective, but they should recognise that it may not be possible to achieve it immediately. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce after the initial period.

#### *Directors' remuneration*

The Combined Code recommends that, to avoid conflicts of interest, boards should set up remuneration committees, consisting exclusively of independent non-executive directors, to make recommendations to the board on the framework of executive remuneration and to determine on their behalf the specific remuneration packages for each of the executive directors.

The Listing Rules require boards of listed companies to report to shareholders each year on directors' remuneration. The report, which should be included within the annual report and accounts, should include full details of all elements in the remuneration package of each individual director by name such as basic salary, benefits in kind, annual bonuses, pension entitlements and long-term incentive schemes including share options. Company law requires all companies, including listed companies, to disclose similar information in aggregate, rather than analysed by individual director.

In October 2001, the government announced that, in order to improve the linkage between pay and performance and strengthen the position of shareholders, it plans to extend the legal disclosures for listed companies and require them to put an annual resolution to shareholders on the remuneration report.

#### *Shareholders*

Company law requires that, for each financial year, the directors of a company prepare and approve a directors' report and annual accounts and lay before the company in

general meeting copies of those documents together with the auditors' report on the accounts.

Each year, every company must hold a general meeting as its annual general meeting (AGM) in addition to any other meetings in that year. The Combined Code recommends that boards should use the AGM to communicate with private investors and encourage their participation. In particular, companies should propose a separate resolution at the AGM on each substantially separate issue and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution after it has been dealt with on a show of hands.

The Combined Code further recommends that companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on a mutual understanding of objectives. However, this should not mean that institutional investors have access to more information, or more timely information, than private shareholders.

#### Accountability and audit

Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

Company law requires that, for all but very small companies, a company's auditors shall make a report to the company's members on the annual accounts laid before the company in general meeting. The auditors' report must state whether, in their opinion, the annual accounts have been properly prepared in accordance with the Companies Act 1985, and in particular whether a true and fair view is given.

#### Internal controls

The Combined Code recommends that directors should, at least annually, conduct a review of the effectiveness of the

group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management. In 1999, the Institute of Chartered Accountants in England and Wales issued guidance to directors on how best to carry out such a review (the Turnbull guidance).

At the heart of the Turnbull guidance is the premise that sound internal control is best achieved by a process firmly embedded within the company's operations. However, the guidance asserts that the board cannot rely solely on such an embedded process, but should regularly receive and review reports on internal control from management. Issues to be considered as part of the regular review process should include the identification, evaluation and management of significant risks; the effectiveness of the related system of internal control and the actions taken to remedy any weaknesses found.

In addition to the regular review process, the guidance proposes that directors undertake a specific annual assessment for the purposes of making the internal control disclosures required by the Listing Rules. This should include, for example, changes in the nature and extent of significant risks, the company's ability to respond effectively to change, the quality of the regular review process and the incidence of significant control failings.

Where compliance with the guidance is achieved, boards should disclose in the annual report and accounts that there is an on-going process for identifying, evaluating and managing the company's significant risks that is regularly reviewed by the board and accords with Turnbull's guidance. Furthermore, a summary should be given of the process the board has applied in reviewing the effectiveness of the system of internal control, together with the process applied to deal with any material internal control aspects of any significant problems disclosed in the annual report and accounts. Where a board is unable to make such disclosures, the board should state this fact and explain what it is doing to rectify the situation.

### Audit committees

The Combined Code recommends that boards should establish audit committees of at least three non-executive directors, the majority of whom should be independent. The duties of the audit committee include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

The principle that auditors are objective and independent from company management is paramount to any auditor/client relationship. Statutory provisions, auditing standards and professional guidance all aim to ensure that this principle is applied in practice.

### Corporate governance survey

The survey was sent to the chairmen of FTSE 350 companies. Twenty eight responses were received. Fourteen responses were from companies falling within the 500 largest European companies (by market capitalisation).

#### The board

In the United Kingdom, the separation of the roles of chairman and chief executive officer is widely recognised as advantageous with some 61% of respondents strongly agreeing that there is benefit in separation. This is not unexpected - as long ago as 1992 the Cadbury Report extolled the virtues of having a “clearly accepted division of responsibilities at the head of a company”. Notwithstanding this, some respondents did recognise that there may be particular circumstances when the roles are combined, sometimes on a temporary basis, particularly for smaller and ‘early stage’ companies.

In all the United Kingdom companies surveyed, non-executive directors comprised more than one third of the board, and in all but 7% of companies the majority of non-

executive directors were considered by the board to be ‘independent’. This is to be expected as the Combined Code recommends that non-executive directors should comprise not less than one third of the board and the majority of them should be free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

Boards appear to meet more frequently in the United Kingdom than in other European countries. Of those responding to the survey, 86% had in excess of seven board meetings in the last financial year, while a significant 29% had more than ten meetings. As expected, there is a general inverse correlation between the frequency of board meetings and the length of meetings in the United Kingdom.

Board meetings appear to be well attended with 57% of meetings being attended by all directors and 89% of meetings being attended by more than three quarters of board members. This contrasts unfavourably with Germany and Switzerland where respondents report that 82% (Germany) and 67% (Switzerland) of meetings are attended by all directors. This may be explained in part by the fact that full board meetings are far more infrequent in Germany and Switzerland.

Directors would appear to have more international experience than many of their European colleagues which may reflect the maturity of the London Stock Exchange and the global nature of many companies listed thereon. It is worth noting that in each geographic market considered, more non-executive directors had international experience than their executive counterparts - it is tempting to assume that this is somehow linked to non-executives being, in general, older and therefore more experienced than executive directors.

In common with the rest of Europe, most directors have more than two years experience in finance (executives 93%, non-executives 89%). Marketing and operational expertise is also prevalent on UK boards with around two-thirds of directors having experience in these areas. The survey results show that, in general, United Kingdom boards

comprise directors with an abundance of experience in each of the three categories (finance, marketing, and operations). Curiously, United Kingdom boards appear to be poorly represented when it comes to experience in technology/research and development.

### *Independence*

The most common tests used to determine directors' 'independence' are that such directors should not: represent a specific shareholder or other single interest group (96%); participate in company share option or performance-related remuneration schemes (93%); have conflicting or cross directorships (89%); or have significant financial or personal ties to the company or its management which could interfere with the director's loyalty to shareholders (96%).

Significantly, a higher proportion of United Kingdom respondents feel representation of single interest groups and participation in share option or performance-related remuneration schemes threaten independence. This may reflect the proliferation of employee representatives in certain countries coupled with the fact that share option schemes are not as prevalent in continental Europe and therefore the arguments surrounding their impact on independence less rehearsed.

Furthermore, far more United Kingdom respondents considered directors not to be independent where they had been employees for more than five years (64%) than the European average (44%). Again, this reflects the proliferation of employee representatives in certain countries. By contrast, only 25% of respondents considered directors to lose their independent status when they had served as a director for more than five years, while in (say) France, this test was supported by 56% of respondents.

### *Stakeholder representation and communication*

In some countries, directors represent specific stakeholder groups. However, in the United Kingdom, directors' duties are owed to the company not directly to its shareholders, albeit directors must have regard for the interests of present

and potential shareholders, and also the company's employees, creditors and other stakeholders. Two respondents indicated that they have directors who represent major shareholders. Nevertheless, as a matter of law, even the duties of these directors are owed to the company itself.

### *Evaluation*

Evaluation of board performance appears to be more prevalent in the United Kingdom with 39% of respondents having a regular process for the evaluation of the board (European average - 17%). Curiously, when it comes to audit committees, the position is reversed even though such committees are more established in the United Kingdom. Only 14% of respondents have a process for the regular evaluation of the audit committee compared to around 65% of respondents from the Netherlands and 25% of respondents from Germany.

Turning to the evaluation of executive directors by non-executive directors, there is little difference between the responses received in each of the countries surveyed - 79% in the United Kingdom and across Europe as a whole. However, when it comes to non-executives evaluating the performance of the chairman, there is a marked difference between France and the UK (54%) and Germany (21%).

The Combined Code recommends that directors should receive appropriate training on the first occasion that they are appointed to the board and subsequently where necessary, so it is no surprise that the vast majority of respondents (89%) confirmed that directors receive appropriate training. However, across Europe as a whole, 53% of respondents did not consider that each director received appropriate training when appointed to the board and subsequently where necessary.

### *Specialised committees*

#### *Audit committees*

As long ago as 1992 the Cadbury report recommended that boards of listed companies set up audit committees, so it is not surprising that the survey shows that such committees

are more established in the United Kingdom than in the rest of Europe. All the companies surveyed had established audit committees (compared to a European average of 67%), and only 18% had been established after 1995. This compares with (say) France where only 80% of respondents had audit committees and of those, 79% had been established after 1995.

The Combined Code recommends that audit committees comprise at least three non-executive directors, the majority of whom should be 'independent'. All respondents had audit committees comprised solely of non-executive directors, and in each case the majority of members were, as the Code recommends, considered independent. This contrasts with the European average where 18% of respondents have audit committees where executives exceed one third of the membership. In Switzerland, which has no code in this area, executive directors account for more than one third of audit committee members in 25% of those companies surveyed.

The timing of the final audit committee meeting prior to finalising the financial statements is broadly consistent with the European average. However, it is interesting to note that 18% of respondents (15% across Europe as a whole) have their final audit committee meeting only one day before the results are finalised. Whether this suggests that, in such cases, the audit committee's review is merely a formality, or alternatively that the committee's ongoing monitoring role negates the need for late adjustments, is open to question.

#### *Remuneration committees*

The Combined Code recommends that remuneration committees should consist exclusively of non-executive directors who are independent. Only two respondents included executive directors on their remuneration committees and all but five had remuneration committees that were wholly comprised of 'independent' non-executive directors. The prevalence of executive directors on remuneration committees is far greater in Belgium and Switzerland where the recommendations are not so tightly drawn.

There is some evidence that remuneration committees meet more frequently in the United Kingdom than elsewhere in Europe (except Germany). Just over a third of respondents had remuneration committees which meet less than three times per annum while in Switzerland half the respondents' remuneration committees met less than three times, and in France, 67%.

#### *Nomination committees*

In 1992, the Cadbury report recommended that companies establish nomination committees, but did not make this part of its Code of Best Practice. Nevertheless, in 1998, this recommendation was incorporated into the Combined Code with the proviso that such committees may not be appropriate for small boards. Furthermore, it was recommended that a majority of the committee members should be non-executive directors. In the United Kingdom companies appear to have little difficulty in this area - all respondents have nomination committees, and in each case a majority of committee members are non-executive directors. A third of respondents had nomination committees comprised solely of non-executive directors.

In stable boards, nomination committees are not expected to meet frequently - 78% of respondents have less than two meetings per annum.

#### *Internal control and risk management*

Respondents generally agreed that their board was aware of the significant risks and opportunities facing their company, and that an effective system of internal control and risk management was in place. One wonders whether this optimism will prove to be well founded if, as many economists suggest, the United Kingdom enters a recession in the near future. Respondents appear to be marginally more bullish than their European colleagues, which is probably due to the impact of the Turnbull report and its focus on the board's responsibility to review the effectiveness of systems of internal control.

When asked whether the system of internal control facilitated the identification, assessment, monitoring and

reporting of significant risks, the vast majority of respondents either agreed or strongly agreed. (Unlike some other countries, no respondents disagreed or strongly disagreed.) Again, the positive response is probably due to the impact of the Turnbull recommendations.

Interestingly, few respondents (approximately 20%) strongly agreed that the system of internal control and risk management was embedded within their organisation or linked to the organisations vision, mission and business objectives - though crucially, the aggregate of those who agreed or strongly agreed was consistent with the European average (approximately 80%). This suggests a hint of scepticism, or perhaps that Turnbull set a high hurdle and there is recognition that more work has to be done in these difficult areas.

Most respondents believed that their system of internal control addressed risks associated with the following categories - markets, products and processes, new technology/research and development, environmental issues, intellectual capital, health and safety, emotional capital and reputation. As a general trend, respondents considered each category (except new technology/research and development) to be more fully addressed by their system of internal control than the European average. This phenomenon is particularly apparent for risks associated with reputational, health and safety and environmental issues. Again, the Combined Code and Turnbull report's emphasis on "all risks including financial, operational and compliance controls and risk management" has probably raised the awareness of non-financial risks within the United Kingdom.

Only 36% of respondents agreed or strongly agreed that the board had identified the value each stakeholder requires compared much higher numbers elsewhere in Europe (all respondents from Germany and 69% of respondents from France). This may well be systematic of the greater influence of stakeholders other than shareholders in many other European countries. Similarly, while respondents strongly agreed that systems were in place to measure the

creation/destruction of shareholder value (82% agreeing or strongly agreeing), only 25% agreed or strongly agreed that such systems were in place to measure the creation/destruction of value for stakeholders other than shareholders. This contrasts with the position elsewhere in Europe where a much higher proportion of respondents considered that systems were in place to measure value for stakeholders other than shareholders.

#### Internal and external audit

A high proportion (86%) of respondents had an internal audit function which is to be expected as both the Combined Code and the Turnbull report give a strong steer in this direction. What is surprising, however, is that some respondents, particularly in Belgium, Switzerland and the Netherlands, do not have such a function. The obvious question is how do the boards of such companies gain assurance over the adequacy of their systems of internal control?

Respondents were generally of the opinion that their internal audit function was well respected within the organisation, seen as a value adding resource and business objective orientated. However, it is perhaps worrying that as many as 94% of Germany respondents agreed (or strongly agreed) that internal audit was a value adding resource, compared with only 72% in the United Kingdom. Internal audit functions appear to be less valued than their overseas counterparts in other areas too. Only 13% of respondents strongly agreed that internal audit serves as a sounding board for directors compared with 47% and 53% in Germany and Switzerland respectively. No respondents strongly agreed that internal audit was a training ground for senior management, unlike France (23%), Germany (32%) and Switzerland (34%).

Across Europe, external auditors appear to be as valued as their internal audit counterparts in each of the five categories - respected within the organisation; seen as a value adding resource; business objective orientated; sounding board for directors; and training ground for senior management.

National trends are generally similar for both internal and

external audit. Auditors of United Kingdom companies are seen as more business orientated and respected than most of their European counterparts (except Germany where auditors are perceived to be very business orientated) while Swiss respondents looked more favourably on both internal and external auditors as a sounding board for directors and training ground for senior management.

Communications between auditors and audit committees on a number of specified areas appears to be more commonplace in the United Kingdom than elsewhere. This may be due to the maturity of audit committees; the influence of the US Blue Ribbon recommendations; or the existence of United Kingdom auditing standards that specifically address communications with those charged with governance (often the audit committee). What is surprising is the lack of communication that exists elsewhere in Europe. For example, all United Kingdom respondents acknowledged that external auditors communicate directly with audit committees on the system of internal control, accounting policies and the financial statements - by contrast, across Europe, only around 60% of respondents considered external auditors communicated with audit committees on these matters.

As expected, respondents considered internal auditors to be more communicative than external auditors on social, ethical and environmental matters, and fraud (as these are generally outside the scope of the statutory audit). By contrast, external auditors were considered more communicative than internal auditors in issues such as accounting policies, the financial statements and auditor independence.

Interestingly, many more respondents from the United Kingdom acknowledged that a dialogue existed with both internal and external auditors on social, ethical and environmental matters than elsewhere in Europe. This may well be due to the importance attached to these areas in recent initiatives such as the Turnbull report and the proposals for the reform of company law. Alternatively, it may suggest a higher take up of initiatives such as ISO 14001

(Standard for environmental management systems) and EMAS (Eco Management and Audit Scheme).

### Disclosure

It is encouraging that almost all the information published in the annual report and accounts is also available on the internet. Detailed information about strategy, performance drivers, environmental issues, and systems of internal control and risk management is widely available. However, the survey suggests that disclosure of key relationships and known events trends and uncertainties that might effect future performance is less prevalent. If the current proposals for a statutory operating and financial review are carried through in their current format, then company law will soon require disclosure of these matters where they are considered material.

### Conclusion

Companies incorporated in the United Kingdom and listed on the London Stock Exchange have clearly achieved a high standards of governance when compared to some of their European counterparts. However, there are still significant concerns. One of the most obvious is the importance of planning for board succession. This may well be the subject of increasing debate, both in the United Kingdom and in Europe, with moves for some form of disclosure that will indicate, as a minimum, that proper plans are in place.



# Appendix



## Useful Web sites

The third party links provided below are for the convenience of our users. KPMG does not control and is not responsible for any of these sites or their content. KPMG is obligated to protect its reputation and trademarks and KPMG reserves the right to request removal of any link to our Web site.

### Belgium

**Merged Code (resulting from the Cardon Report and the Banking and Finance Commission Report) -**  
[www.cbf.be/pe/pec/en\\_ec01.htm](http://www.cbf.be/pe/pec/en_ec01.htm)

**Guidelines on Corporate Governance Reporting (in French) -** [www.cbf.be/pe/pec/fr\\_ec02.htm](http://www.cbf.be/pe/pec/fr_ec02.htm)

**Corporate governance recommendations (Federation of Belgium Enterprises) -**  
[www.ecgn.ulb.ac.be/ecgn/docs/codes/VBO-FEB-en.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/VBO-FEB-en.pdf)

### France

**Viénot I Report (in French) -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/vienot1-fr.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/vienot1-fr.pdf)

**Viénot II Report -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/vienot2-en.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/vienot2-en.pdf)

**AFG-ASFFI -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/recgegb.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/recgegb.pdf)

### Germany

**Report of the German Government Committee on Corporate Governance -** [www.ovs.de/corporate\\_governance.htm](http://www.ovs.de/corporate_governance.htm)

**German Code of Corporate Governance -** [www.gccg.de/eng\\_German-Code-of-Corporate-Governance.pdf](http://www.gccg.de/eng_German-Code-of-Corporate-Governance.pdf)

**Corporate Governance Rules for German Quoted Companies -** [www.corgov.de/download/code0700e.pdf](http://www.corgov.de/download/code0700e.pdf)

**Scorecard for German Corporate Governance -** [www.dvfa.de/pdf/scorecard.pdf](http://www.dvfa.de/pdf/scorecard.pdf)

### Italy

**The Preda Code -** [www.borsaitalia.it/media/pdf/code\\_autodisc/cod\\_di\\_autoregol\\_ing.pdf](http://www.borsaitalia.it/media/pdf/code_autodisc/cod_di_autoregol_ing.pdf)

**Law reform based on the Draghi proposals -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/TestoUnico\(eng\).pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/TestoUnico(eng).pdf)

### Netherlands

**Corporate governance in the Netherlands (the Peters report) -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/nl-petersreport.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/nl-petersreport.pdf)

### Switzerland

**Swiss Exchange: proposed disclosure requirements: -** [www.swx.com/admission/cg\\_intro\\_en.html](http://www.swx.com/admission/cg_intro_en.html)

**Economiesuisse: proposed code -** [www.economiesuisse.ch/d/fokus/schwerpunkt.htm?id=35&sid=53](http://www.economiesuisse.ch/d/fokus/schwerpunkt.htm?id=35&sid=53)

### United Kingdom

**The Financial aspects of Corporate Governance (the Cadbury Report) -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/cadbury.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/cadbury.pdf)

**Directors Remuneration (the Greenbury report) -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/greenbury.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/greenbury.pdf)

**Committee on Corporate Governance (the Hampel Report) -** [www.ecgn.ulb.ac.be/ecgn/docs/codes/Hampel2/hampel2.htm](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/Hampel2/hampel2.htm)

**Internal control: Guidance for Directors on the Combined Code (the Turnbull Report) -**  
[www.ecgn.ulb.ac.be/ecgn/docs/codes/turnbul.pdf](http://www.ecgn.ulb.ac.be/ecgn/docs/codes/turnbul.pdf)



