



2004 AMF REPORT
on information published by public
securities issuers
and internal control procedures

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INTRODUCTION

Financial Security Act of 1 August 2003

The Financial Security Act (*loi de sécurité financière* – LSF)¹ introduced new requirements on disclosures to shareholders and the market for the purposes of corporate governance and internal control.

The chairman of the board of directors or the supervisory board of any limited-liability company is now required to make an annual report to the shareholders on how the board prepares and organises its work (“corporate governance”) and on the internal control procedures implemented by the company. This report is appended to the management report and, in the case of a limited-liability company with a board of directors, it must also report “*any restrictions that the board of directors has placed on the powers of the chief executive officer*” (Article 117).

External (or “statutory”) auditors are required to present “*their observations*” on the section of the chairman’s report dealing with “*internal control procedures relating to financial reporting*” in a report appended to their general report on the annual financial statements. This means that the external auditors’ report does not contain any observations about other internal control procedures or about the information provided on corporate governance practices (Article 120).

Furthermore, public issuers of securities (i.e. which are listed or have made a public offering of securities) are required to disclose information on corporate governance, internal control procedures and any restrictions on the powers of the chief executive in compliance with Article 122 of the General Regulations of the Autorité des marchés financiers (AMF), the French securities regulator.

The AMF is required to compile an annual report based on the information published by public issuers with regard to the matters stipulated in Article 117 (ultimately, Article 122). This document is that report.

The new requirements apply to financial years starting on or after 1 January 2003. The new Act does not contain any transitional provisions for a gradual phasing-in of the new requirements, nor does it provide for any implementing decrees to define or specify application procedures.

Market-wide standards

The industry professionals concerned by the new provisions decided to set up a market advisory group to draw up guidelines for public issuers. The group was made up of representatives of external auditors (*Compagnie nationale des commissaires aux comptes* – CNCC), associations representing securities issuers (*Association française des entreprises privées* – AFEP, *Mouvement des entreprises de France* – MEDEF, *Association nationale des sociétés par actions* – ANSA), internal auditors (*Institut de l’audit interne* – IFACI), the ministry of justice and the *Commission des Opérations de Bourse* (COB), which later became the AMF.

¹ Act 2003-706 of 1 August 2003: Article 117 (amending Articles L.225-37 and L.225-68 of the Commercial Code), Article 120 (amending Article L.225-235 of the Commercial Code) and Article 122 (amending Article L.621-18-3 of the Monetary and Financial Code).

After the market advisory group deliberated, AFEP and MEDEF jointly drafted a document² that contains guidelines for issuers with regard to the scope and contents of the chairman's report. ANSA also drafted a memorandum³ on the legal interpretation of the new provisions.

The AFEP/MEDEF guidelines and the ANSA legal analysis provide very helpful information for public securities issuers on how to draft the chairman's report. The AMF, noting the existence of these guidelines, urges public securities issuers to follow them, especially the principles and procedures to be applied when drafting the section of the chairman's report describing internal control procedures (see below).

Further guidelines from the AMF

The new Act stipulates that the AMF can intervene in two ways: through its General Regulations, which define how the information stipulated in Article 117 is to be disclosed, and through the publication of an annual report based on the information disclosed by securities issuers.

In view of the rapid implementation of the new Act, the AMF decided to publish a set of guidelines entitled "Corporate governance and internal control – Disclosure and publication requirements for securities issuers" in January 2004 so that issuers would have guidelines on the desired level of information on internal control as soon as possible. These guidelines are also intended to make securities issuers aware of the direction that the AMF would like to take in its own report, since the value added of that report relies primarily on the contents of securities issuers' publications.

On corporate governance information

In its previous guidelines on drafting registration documents⁴, the AMF referred to the market advisory group's recommendations on corporate governance⁵, by stipulating that "*companies making public offerings of securities should provide a transparent description of the corporate governance rules that they follow.*"

Article 117 of the Financial Security Act does not refer to the concept of corporate governance per se. Nevertheless, the key concern of the lawmakers corresponds broadly to the guidelines set out in the market advisory group's reports mentioned above. Therefore, the AMF deems that it would be helpful for a securities issuer subject to the requirements set out in Article 122 of the Financial Security Act to continue following the guidelines set out in these reports and to specify whether its own practices differ from these guidelines and why.

On internal control procedures

The AMF document stipulated that the report should describe the due diligence underlying the analysis presented by the chairman, such as interviews with senior management, discussions at the level of the board of directors, meetings with the external auditors and the audit committee, where applicable.

The AMF also reminds external auditors of their obligation to report any problems encountered during an audit to the corporate bodies, including any material deficiencies discovered in internal control procedures⁶. When the external auditors inform a chairman of such shortcomings, he should mention them in his own report.

² AFEP/MEDEF guidelines published on 17 December 2003, entitled "*Enforcement of the Financial Security Act with regard to the chairman's report on internal control procedures established by the company*".

³ ANSA legal committee memorandum dated 5 November 2003, No. 3267.

⁴ *Bulletin mensuel COB*, January 2003, No. 375, p. 17s and *Revue mensuelle de l'AMF*, March 2004, No. 1, p.39s.

⁵ These recommendations are found in the joint AFEP/MEDEF reports, or the Viénot Report of July 1995 and the Bouton Report of September 2002. These recommendations have been consolidated in a joint AFEP/MEDEF document entitled "*Corporate governance for listed companies*" published in October 2003.

The AMF wants this approach to be part of a dynamic process, culminating eventually in each issuer's making an assessment of the adequacy and effectiveness of its internal control systems. Therefore, the AMF encourages issuers that already have an internal control assessment for 2003 to present a summary of the assessment in their report and, where applicable, to identify areas for improvement.

Furthermore, the AMF reminds securities issuers that COB regulations require companies to make an immediate disclosure of any information that would have a significant impact on their share price, or any material change in information that has already been disclosed. Such disclosures would be required in the event of an internal control failure or material deficiencies identified in the assessment process or in the due diligence performed in connection with the report⁷.

Further guidelines in the AMF General Regulations

As the lawmakers intended, the AMF General Regulations, published on 24 November 2004, define how internal control information is to be published, specifying the timing, the form and the dissemination channels. Companies making public offerings of securities must comply with these regulations, as well as the requirements set out in company law. The General Regulation articles⁸ dealing with internal control information are appended to this report.

Article 221-6 of the AMF General Regulations deals with the timing and format of the information disclosed, specifying different rules for three types of cases:

- The first case concerns limited-liability companies, which have to publish the reports required by law no later than the date on which their management reports are filed with the commercial court registry.
- The second case concerns companies⁹ that make public offerings and "*disclose information relating to the matters stipulated in the last paragraphs of Articles L.225-37 and L.225-68 of the Commercial Code*" under the conditions mentioned above, if they are required to file their financial statements with the commercial court registry.
- The third case concerns other companies that make public offerings and "*disclose information relating to the matters stipulated in the last paragraphs of Articles L.225-37 and L.225-68 of the Commercial Code as soon as*¹⁰ *the annual financial statements for the previous financial year have been approved.*"

This means that the AMF maintains its stance that companies incorporated in other countries, limited partnerships, and even unincorporated securities issuers, are all required to disclose the information mentioned above, even though the laws of France or their country of origin do not require them to produce an official report for their shareholders' meeting. This information can be disclosed in the format best suited to the securities issuer's legal structure.

⁶ Compagnie nationale des commissaires aux comptes Standard 2-107.

⁷ Article 4 of COB Regulation 98-07 (reproduced in Article 222-3 of the AMF General Regulations). Securities issuers must also disclose any findings of an internal control evaluation that could have an impact on the issuer's or the group's financial situation.

⁸ Book II "Issuers and financial information", Title II "Periodic and event-driven disclosures", Chapter 1 "Periodic disclosures", Section 2 "Information on corporate governance and internal control".

⁹ The external auditor's report on internal control stipulated in Article L. 225-235 of the Commercial Code concerns only limited-liability companies incorporated in France. However, if the external auditors of other entities making public offerings of securities produce opinions nonetheless, they should be included.

¹⁰ The words "*as soon as the annual financial statements for the previous financial year have been approved*" were preferred to the vaguer notion given by "*shortly after closing the accounts of the previous financial year*" in the January 2004 guidelines.

Application of the laws and regulations

Compliance with publication rules

As of 30 September 2004, all of the registration documents filed with the AMF have contained a report from the chairman with information relating to the matters stipulated in Article 117 of the Financial Security Act (except for one foreign company that included only the section on corporate governance) and an external auditors' report in the case of all French limited-liability companies.

A number of companies that do not produce a registration document did not follow the January 2004 AMF guidelines when publishing their reports. By the end of September, the AMF had sent these companies a total of 341 requests for corrections.

Depending on the responses to these requests and in light of the quality of reports published by the companies receiving such requests, the AMF will determine what further action is warranted. In the next financial year, notwithstanding any procedures undertaken to obtain corrections, the list¹¹ of securities-issuing companies that have not met the requirements for publishing reports set out in the AMF General Regulations could be posted on the AMF website.

Report formats

The number of pages contained in the reports varies from two to more than twenty. As a general rule, the section dealing with corporate governance is longer than the section on internal control procedures.

The chairmen of companies in the banking and insurance industries, or companies subject to the Sarbanes-Oxley Act in the USA, presented the longest, and the most detailed, reports. Banks and insurance companies have been subject to strict regulation for several years now and companies listed on American stock exchanges have had to make a major effort to present their action to improve their internal control systems.

Including the reports in registration documents

In the vast majority of cases, chairmen's reports are presented separately from the rest of the registration document, in a clearly identified section entitled "Chairman's Report", especially in the case of smaller companies.

Some companies have drafted stand-alone reports, but these still refer readers to a chapter of the registration document entitled "Corporate governance" for further details on how the board prepares and organises its work (operations, committees) or to the section on the risks described in the management report. On the other hand, some companies include a section on corporate governance in their registration document with footnotes indicating that certain passages are part of the chairman's report.

No matter what form the presentation takes, it must help make the report easier to read. If the chairman's report is broken up into parts and scattered throughout the registration document, this must be clearly stated in the body of the report; and when companies submit an annual report as a registration document, they must provide a clear cross-reference table for finding the information required in the chairman's report.

¹¹ Such a list has been posted since 2003 for companies traded on regulated markets that have not published their quarterly results, half-year results or annual financial statements drawn up by the board of directors and approved by the annual shareholders' meeting in the *Bulletin des annonces légales obligatoires* (BALO) as required by law or for companies traded on the Nouveau Marché that have not filed their registration documents on time.

1 INTERNATIONAL ENVIRONMENT AND METHODOLOGY

1.1 International environment

Corporate governance and internal control systems will go through various changes at the international level over the next few years:

- **Sarbanes-Oxley Act** (Section 404 – Management Assessment of Internal Control) was passed in 2002 and enters into force in 2004 and 2005. The Act requires a multi-stage analysis of internal control leading up to an assessment of accounting and financial control under the responsibility of the chief executive officer and the chief financial officer. The dates for compliance vary for different types of companies. As a general rule, the new Act applies to financial years ending on or after 15 November 2004 for companies identified as “accelerated filers”, meaning companies incorporated under American law with a common equity public float of at least USD 75 million, if they have been subject to the Exchange Act reporting requirements for at least 12 months and have previously filed at least one annual report. The new Act applies to companies identified as “non-accelerated filers” starting on 15 July 2005. Companies incorporated under foreign law will also have to comply with the requirements of the Sarbanes-Oxley Act for financial years ending after 15 July 2005.
- The April 2004 report by the **Organisation for Economic Co-operation and Development** (OECD) on corporate governance principles constitutes a charter endorsed by all of the OECD countries and includes passages on the responsibilities of boards of directors.
- The **European Commission** published a proposal to amend the Eighth Company Law Directive¹². Article 39 of the proposed Directive stipulates that public interest entities shall have an audit committee and describes its members and tasks. One of the audit committee's tasks is to “*monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems*”. Further more, the proposed Directive requires the external auditor or audit firm to report to the audit committee, in particular on “*material weaknesses in internal control in relation to the financial reporting process*”.
- On 6 October 2004, the **European Commission** published two recommendations on corporate governance for listed companies. The Commission calls for a reinforcement of the role played by independent directors and proposes guidelines on disclosure and oversight of directors' remuneration. In view of the differences in national practices concerning corporate governance, the Commission ensured that Member States had the necessary flexibility to apply the principles set out in its recommendations. However, “*Member States are invited to take the necessary measures to promote the application of the principles set out in [these] Recommendation[s] by 30 June 2006 and to notify the Commission of the measures taken in compliance with [these] Recommendation[s], in order to allow the Commission to monitor closely the situation and, on this basis, to assess the need for further measures.*”
- On 28 October 2004, the **European Commission** published a proposal for amendments to the **European Accounting Directives**¹³. The Commission proposes that all listed companies in the European Union should be required to publish a “corporate governance statement” in their annual report. This statement would contain key information, such as: a reference to the corporate governance code the company decided to apply or is subject to under the law of the Member State where it has its registered seat, with an explanation of which parts of the code it departs from and the reasons for doing so, a description of the company's internal control and risk management systems, and the composition and operation of the board and its committees.

¹² Proposal for a Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC.

¹³ Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts.

1.2 Methodology used to compile this report

The purpose of this report is to gauge the added value of information provided to the market on corporate governance and internal control systems at companies making public offerings of securities. The preferred approach is based on a qualitative assessment of the information disclosed in order to reveal best practices in these areas. This means that the statistical approach relating to the forms that reports take is deemed to be secondary.

1.2.1 Sample

The analysis of disclosures by public securities issuers was made as of 30 September 2004 on a sample of 118 reports. A detailed analysis of the sample used and the list of the companies in the sample can be found in the appendix to this report.

1.2.2 Methodology for analysing reports

Corporate governance information

This section of the chairman's report is analysed on the basis of the market advisory group's corporate governance recommendations and the AMF guidelines for registration documents concerning the 2003 financial year.

Internal control procedures

The section on internal control is analysed on the basis of elements taken from the AFEP/MEDEF guidelines published on 17 December 2003, the ANSA Legal Committee memorandum dated 5 December 2003, and the AMF guidelines published on 23 January 2004.

The AFEP/MEDEF guidelines are used to analyse the general organisation of internal control procedures with regard to the players, specific structure(s) responsible, division of roles and interactions, along with the presentation of the internal control procedures that are most helpful for financial reporting. The analysis then uses the AMF recommendations on the due diligence to be performed in connection with the report, reporting any material deficiencies, assessing internal control procedures and improvements planned for the following year. Then, each report is analysed to determine what progress the companies have made with regard to the key aspects of internal control, such as: the control environment, risk assessment, control activities, reporting on control activities and oversight of internal control carried out in the company.

1.2.3 Interviews with securities issuers and audit firms

The AMF wanted to supplement its analysis of documents with face-to-face meetings with a number of securities issuers and audit firms. This process, which focuses on the practical experience of the players concerned, is undertaken to gain a better understanding of the work companies have done to improve corporate governance and internal control, along with the methods they have used to document, test and assess the effectiveness of their procedures, as well as the limitations revealed by this work. The interviews were conducted in October 2004.

The main questions deal with:

- the channels that companies use to disseminate their reports,
- the scope of the reports,
- any problems that came up when drafting the reports,
- plans for the 2004 financial year in terms of the content (planned internal changes) and the form of their reports (transparency of the information in their reports),
- any risk mapping actions undertaken and the disclosure of this type of information,

- the level of transparency with regard to the due diligence performed in connection with the report,
- the prospects for ultimately conducting an assessment of the adequacy and effectiveness of internal control procedures,
- the role of external auditors and their level of involvement,
- any questions raised by shareholders when the reports are presented at general meetings,
- the cost of implementing internal control monitoring, including periodic assessments,
- the appropriateness of setting French or European internal control standards that would be recognized by all parties.

1.2.4 Other research published in this area

The AMF monitored research, surveys and other work published by audit firms and specialist bodies during the year, including work by IFACI¹⁴ and IFA¹⁵. The literature includes detailed analysis of the contents of the reports from the largest companies listed on the Paris Bourse (companies in the CAC 40 stock index or samples of companies in the SBF 120 index). Most of this analysis focuses solely on the internal control section of the reports.

The main underlying trends revealed by this literature corroborate the AMF's observations, particularly with regard to the guidelines it issued in January 2004. However, it should be noted that the AMF sample is supposed to represent all companies making public offers of securities. This means it is less uniform than the samples used in this literature and it contains a large number of smaller listed companies, as well as bond issuers. Therefore, the research by industry bodies involved analysis of reports that contain much more statistical information than is given here, since the AMF has decided to highlight more general observations in certain areas and to reveal best practices.

Furthermore, some of the literature deals with subjects that the AMF has not examined directly in the past year and thus enhances the regulator's understanding of these areas. This is the case of detailed analyses that identify the specific features of certain lines of business, differences between companies subject to American rules and those that are not, and new responsibilities of managers.

¹⁴ Institut Français de l'Audit et du Contrôle Interne.

¹⁵ Institut Français des Administrateurs.

2.1 How boards prepare and organise their work

2.1.1 Board organisation and operations

Composition of the board of directors

The analysis shows that most reports give a very specific description of the general composition of boards, with the number of members, directors' ages, arrival and departure dates for directors, directorships held at other companies, and so on.

More than two-thirds of the companies in the sample report that their board includes one or more independent directors. In slightly less than half of the companies, independent directors hold the majority of the seats on the boards.

The independence criteria used are defined by more than 80 per cent of the companies where the board includes one or more independent directors. Nearly two thirds of these companies explain that they use the criteria set out in the Bouton Report and one quarter of them use their own criteria. In addition, nearly 10 per cent of the companies explain that they use a streamlined version of the criteria set out in the Bouton Report. More specifically, some companies explain that they exceed the 12-year term limit on directorships set out in the Bouton Report¹⁶.

The role of the board

Some 40 per cent of the companies give a clear definition of the board's tasks.

About half of the companies report that they have rules of procedure to define how the board is organised and how it operates, as well as defining the directors' powers and responsibilities. Among these companies, 15 per cent explain that the rules of procedure were adopted in 2003. Nearly two thirds of the companies provide passages or a summary of their rules of procedure to illustrate certain points covered in their reports, either indicating that the rules of procedure were appended to the report or can be consulted at the head office or on the company website. The other companies merely mention the existence of their rules of procedure and/or provide the date on which they were adopted or the areas covered by the rules, without saying where the rules could be consulted.

The rules of procedure presented in companies' reports generally deal with the following issues: composition of the board, board meetings, information for directors, board deliberations, directors' transactions in the company's shares, procedures for remunerating directors, transactions requiring prior authorisation from the board, procedures for evaluating the board's performance, etc.

Finally, 13 per cent of the companies that already have rules of procedure in place explain that they have recently amended these rules or plan to do so in the near future. For example, a company reports the following amendments to its rules: "*Plans call for the rules of procedure to be supplemented soon with provisions to stipulate the procedures*

¹⁶ A CAC 40 company explains that "*the board of directors followed the recommendations of the Bouton Report to assess the independence of the directors. However, the board of directors decided to phase in application of the recommendation regarding directors who have served more than twelve years and the board has set the objective of achieving compliance within two years and thus to plan the necessary changes to the board*".

for the board to conduct its own evaluation of its performance, including a detailed questionnaire that will be sent to each director asking about the composition and performance of the board and its committees. The completed questionnaires will be examined and summarised by one of the two controllers, and a report will be submitted to board for discussion, assessment and recommendations.”

Board meetings

On the whole, the chairmen's reports discuss the commitment of the directors. Fully 87 per cent of the reports say how many times the board met. Attendance rates at board meetings are reported in 83 per cent of the reports. The rates vary from 60 per cent to 100 per cent. Nearly three quarters of the companies report an attendance rate of 80 per cent or more at their board meetings.

Nearly half of the companies report that preparatory documents are given to directors before the meetings.

Only half of the companies in the sample report on the issues discussed at the board meetings during the year. Those that do report on the issues discussed often do so in general terms. For example, a company in the SBF 120 stock index explained that *“the board of directors discussed, examined or adopted the following points: the group's activities, strategic choices, interim and final financial statements and forecasts, industrial relations, external growth plans and operations, current “regulated agreements”, the amount of guarantees given by the company, capital increases for employees and the employer's contribution to employee stock ownership schemes, distribution of stock options, the share redemption programme, executive remuneration, distribution of directors' fees, reduction of capital through the cancellation of acquired shares, convertible bond issues, adoption of rules of procedure and a director's charter.”* Other companies provide more detailed reports of each board meeting and some of them explain which issues were discussed at extraordinary board meetings.

After reading several reports, it becomes clear that directors are increasingly expected to show a stronger commitment in terms of attendance, involvement, professionalism and the time they spend on their duties (see the Board performance evaluation).

2.1.2 Specialised committee organisation and operations

Some 75 per cent of the companies in the sample reported that they have specialised audit, remuneration and nomination committees, in keeping with the AFEP/MEDEF corporate governance principles. More than half of the companies have set up two or more committees. The remuneration committee and the nomination committee are often merged into a single body. These committees clearly assist the board of directors in dealing with such sensitive issues as auditing the financial statements, monitoring internal audit systems, appointing external auditors, remuneration policy and the appointment of directors and corporate officers.

The number of committees responsible for the preparing recommendations for the board's decisions is growing each year, and committees are being set up to deal with a wider range of issues. Companies, especially medium-sized corporations, have made an effort to meet the guidelines and some of those that did not yet have them have set up one or more specialised committees in the last year. Some 7 per cent of the companies in the sample that did not yet have a committee set up one or more in 2003.

Some companies that do not have specialised committees included a section in their report on internal committees chaired by the chairman of the board, such as strategy or executive committees. Executive committees are described as providing information, coordination and decision-making on issues concerning the group and acting as a conduit for the dissemination of information to the various divisions and departments in the company.

The descriptions of the tasks of the boards and committees are improving. Some committees have adopted rules of procedure that specify their mandate, their terms of reference and their operating procedures. However, their activity in the preceding year is often described in very general terms.

Audit committee

Some 65 per cent of the companies in the sample have set up an audit committee.

The main tasks of the audit committee, as described in the reports, include: examining financial statements, relations with external auditors and, more particularly, inspecting the auditors' work and overseeing the selection and appointment procedure¹⁷, examining off-balance sheet risks and liabilities, validating internal audit systems and, where applicable, evaluating internal control systems.

Many companies report that the audit committee is involved in drafting the internal control section of the report. The audit committee receives internal audit reports or summaries of these reports. It gives its opinion on the internal audit work programme and the recommendations made by internal auditors. The analysis of the reports shows that the audit committee is usually involved in overseeing work and programmes to achieve compliance with the requirements set out in the new Financial Security Act. The reports also describe the supervisory role of the audit committee, which reviews the work and reports of the internal audit function and the annual audit plan. One group's report states that the audit committee "*reviews the organisation and resources of the internal audit function, along with the internal audit plan and the summary of the reports on the audits carried out.*"

Remuneration committee

The remuneration committee, which is mentioned by 58 per cent of the companies in the sample, plays a key role in determining the variable portion of corporate officers' pay. To do so it reviews aggregate pay and benefits. Sometimes, the committee asks outside remuneration consultants for advice. Very few companies give specific information about the criteria that the committee uses to assess proposals concerning the variable portion of corporate officers' pay and few details about the links between pay and market growth, peer group comparisons and the absolute and relative performance of the company.

Nomination committee

Some 41 per cent of the companies in the sample have set up a nomination committee or a nomination and remuneration committee.

The task of the nomination committee is to make proposals for appointing directors and senior managers.

Other committees

The reports also mentioned the existence of other specialised committees that assist the board in specific areas, such as risk, strategy, investment and ethics.

It is noteworthy that a handful of companies in the sample report that they have a risk committee. This committee's task is to provide methodological support for line divisions in the identifying, evaluating and managing risk through risk prevention, risk reduction and risk transfers.

¹⁷ A CAC 40 company explains that "*to reach a reasonable judgment about the selection and renewal of external auditors, the committee shall review the selection procedure, give its opinion on the choice of auditors and the rotation of partners. It shall review the nature of their work and the amount of their fees.*"

2.1.3 Performance assessment of the board and/or specialised committees

Nearly one quarter of the companies in the sample report that they evaluate the collective performance of the board and, in some cases, the performance of the committees.

Of the companies that conducted a performance assessment of their board in 2003, 20 per cent called on outside consultants to do so. About half of these companies report that they will repeat the evaluation every year. Nearly a quarter of the companies reported that 2003 was the first year in which they conducted such an assessment of their board.

Companies provide few details about how the board assessment were carried out, and some companies merely include a statement in very general terms, such as "*the directors reviewed their practices over the year*". However, some companies explained the evaluation procedures and the areas covered by the assessment. Two such passages are quoted below:

- The assessment was "*conducted by an outside firm that sent in consultants who interviewed each director individually on the basis of their answers to a detailed questionnaire that they had filled out earlier on the board's structure, operating procedures and results*".
- "*The evaluation of the board for 2003 was conducted in the first quarter of 2004 under the responsibility of the nomination and remuneration committee. It was conducted by the chairman of the committee using a detailed questionnaire and individual interviews. The committee analysed the answers and then presented them*" at a board of directors meeting.

Only 46 per cent of the companies reported the results of the assessment. They often report positive findings on the operations of the board and present areas for improvement in some cases.

The following passages are quoted from reports of companies providing information about areas for improvement, which was the case of 31 per cent of the companies conducting assessments of their boards.

- *According to the consultants, 'the directors' assessment of the management of the group and the board's operations was unanimously positive' and only a few improvements or new procedures were suggested. These concern strengthening the industrial and scientific expertise of the board, the organisation and timeliness of the documents provided to directors before meetings, organisation of deliberations, the development of relations between directors and management employees who are not corporate officers, organisation of the process for developing strategy and the involvement in the board in the work of the executive committee on the succession of the chairman."*
- "*Several changes were made to the operating procedures of the board, some of which entailed amendments to the rules of procedure and the director's charter with regard to information provided to the board, the content and organisation of board meetings and the tasks and operating procedures of the committees."*

2.2 Restrictions that the board of directors places on the chief executive officer's powers

Not all of the chairman's reports provide information about restrictions on the chief executive officer's powers. Only 30 per cent of the companies with a board of directors, which make up 72 per cent of the companies in our sample, report any such restrictions. Nearly a quarter of the companies provide no information on this subject.

Among the companies that do report on the subject:

- Some explain that the board of directors has not yet placed any specific restrictions on the powers of the chief executive officer. A few explain that the chief executive officer's powers are those stipulated by law.
- As a general rule, the restrictions reported relate to major strategic decisions that are likely to have a substantial impact on the company's finances and liabilities or those of one of its main subsidiaries. The restrictions that reports often cite are: setting the group's strategy, entering into strategic alliances, major internal restructuring and/or diversification, financial transactions that will have a substantial impact on the company's or the group's finances, asset acquisitions and disposals worth more than a given amount, special authorisations for borrowing, lending, giving sureties and guarantees, all agreements and settlements relating to disputes involving more than a given amount.
- One company merely explains in general terms that the "*chief executive officer carries out his functions without any special restrictions, without prejudice to the powers explicitly attributed to the board of directors by law, company bylaws and the rules of procedure*".

Companies highlight the separation of powers between the chairman and the chief executive officer, explaining their respective functions, but do not deal with restrictions that the board places on the chief executive officer's powers *per se*.

The chairman's report must present all restrictions stemming from practices and/or internal rules, as well as those stemming from the rules governing the decision-making process with regard to areas and transactions that have to be referred to the board of directors, with a distinction drawn between matters that require prior approval from the board and matters that require special and periodic reports to the board. In cases where these restrictions are official, the report could refer readers to the company's rules of procedure.

3 INTERNAL CONTROL PROCEDURES

3.1 Description of internal control procedures

3.1.1 The scope of the reports

Our analysis shows that the scope of the reports is not always defined, particularly with regard to restricting the scope of the report to the head company in the group or extending it to other companies under its control. Some companies explain that internal control of activities outside of France is covered by special procedures or that more streamlined procedures are applied to such companies. Some companies also exclude entities in which they hold an equity investment, explaining, for example, that *“the procedures described apply to the group’s companies consolidated under the full consolidation or equity methods, except for company X. Its internal control system description is reproduced from its own registration document for financial year 2003 submitted for its listing on the Premier Marché of the Paris Bourse”*.

The vast majority of companies follow the AFEP/MEDEF guidelines in this area and focus primarily on the internal control procedures aimed at ensuring the accuracy of the accounting and financial consolidation process.

Yet the description of subsidiaries’ internal control systems, where they differ from the systems used by the parent company for historic reasons, provides an overview of companies’ fundamental operational structures.

The interviews reveal that when subsidiaries are incorporated as limited-liability companies, they prepare shorter reports, modelled after the report by the parent company, but that the main emphasis is on the parent company’s report. The chairmen of holding companies rarely rely on subsidiaries’ reports when drafting their own reports. They tend to prefer a pyramidal reporting system to obtain the necessary information using a prescribed process, such as one based on “letters of representation” from the various line and financial managers. Most of the reports deal with the “group” procedures, but some only report on the procedures applied at the parent company or the lead holding company.

It would be better if the information were provided at group level in all cases and any differences between the group’s internal control systems and those of its large subsidiaries should be clearly explained. An explanation of the group’s future plans for internal control, such as maintaining or eliminating different systems and planned measures, could also be helpful.

For example, one group clearly explains that, *“the group’s internal control rules apply to all of the companies under the company’s control or companies where it exercises operational management control. The group’s priority is to implement its internal control system in consolidated companies and, more specifically, in the X companies (out of the Y consolidated companies in 2003) that account for W per cent of the total consolidated turnover”*.

3.1.2 Report structure

As a general rule, the companies’ reports followed two types of framework: the one set out in the AFEP/MEDEF guidelines or the one based on the American COSO standard (Committee on Sponsoring Organisations of the Treadway Commission).

The vast majority of the companies used the market-wide standard framework, to wit:

- The company's objectives with regard to internal control procedures,
- A summary of the internal control procedures in place: general organisation of internal control procedures with regard to the players, specific structure(s) responsible, division of roles and interactions, along with a summary presentation of the company's internal control procedures.
- A presentation of the internal control procedures relating to financial reporting.

Some other companies have chosen to present their report on internal control procedures using the five components of the COSO model, namely control environment, risk assessment, control activities, information and communication, and monitoring.

Other companies have adopted their own framework, which sometimes combines elements from the two outlines mentioned above.

Virtually all of the reports contain a special section on internal control procedures relating to financial reporting. This presentation is in line with the wishes of the CNCC¹⁸ and the AFEP/MEDEF guidelines, since the external auditor's report is required to present the auditor's observations only on this type of information.

Overall, the big differences in the ways companies present their procedures and their main risks are a reflection of the diversity of organisational structures and the lack of standardisation or recognised benchmarks. In formal terms and in terms of comparisons between companies and industries, the wide structural variation in reports seriously hampers our ability to gain a better understanding in this area.

3.1.3 Internal control definitions and objectives

Even though they do not define the notion of internal control per se, 92 per cent of the reports explain the objectives set for internal control procedures. As a general rule, the reports refer to the objectives set by the various bodies and commissions (AFEP/MEDEF, COSO, CNCC, IIA¹⁹, etc.).

These objectives are defined as follows:

- According to COSO, "*internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.*"
- According to the definition used by the CNCC, which is drawn from international audit standards²⁰, internal control procedures involve: compliance with management policies, safeguarding assets, preventing and detecting fraud, accuracy and completeness of accounting records, and timely production of reliable accounting and financial information.
- The definition given by AFEP and MEDEF explains that the purpose of internal control procedures is to: "*ensure that management actions or transactions, as well personal behaviour, are consistent with the business orientations set by the corporate decision-making bodies, consistent with laws and regulations, and consistent*"

¹⁸ Technical opinion of the National External Auditor's Institute dated 23 March 2004: "*In terms of presentation, it would be helpful for the report to contain separate paragraphs on the procedures relating to financial reporting on which the auditor is required make observations*".

¹⁹ Institute of Internal Auditors

²⁰ CNCC Standard 2-301 "Risk evaluation and internal control", § 08, Référentiel normatif CNCC, July 2003

with the company's internal values, standards and rules, as well as ensuring that the accounting, financial and management information provided to the corporate decision-making bodies gives a true and fair representation of the company's situation.

In addition, nearly 50 per cent of the companies mention that one of the objectives of internal control is to prevent and manage risks arising from the company's business activity.

The inherent limitations of internal control procedures are mentioned by 80 per cent of the companies in the sample. With regard to these limitations, the companies use either the COSO wording, which explains that internal control can only provide "reasonable assurance" regarding the achievement of the objectives, or else they use the AFEP/MEDEF wording, which states that "as is the case with any control system, it cannot provide an absolute guarantee that risks will be completely eliminated", or else they combine elements from both.

3.1.4 Conceptual framework or benchmark used

Before reporting on the procedures that are deemed to be significant, it would be helpful to use a conceptual framework for internal control as a benchmark. Then comparisons could be made with the existing system to make sure that it includes all of the expected components. Unlike the American regulations, the French legislation does not require companies to follow a specific set of standards. Given the lack of a common set of standards, companies' internal control systems adhere to a variety of external and internal standards. However, more companies prefer to use their own internal standards rather than one or more external standards.

The reports of 21 per cent of the companies explain that they apply the COSO standards, at least in part. A further 5 per cent of the reports in the sample refer explicitly to other external standards set by various bodies, such as the IIA or IFACI.

The reports mention the use of the following internal standards, in order of importance: ethical charters, codes of conduct that primarily apply to dealings with internal and external partners, such as suppliers and employees, accounting procedure manuals, internal procedure manuals, internal audit charters and internal control manuals. The reports also mention the following frameworks to a lesser extent: reporting and consolidation manuals, "quality" manuals, audit committee charters, codes of conduct for dealings between external auditors and their organisations.

All in all, it is relatively difficult to make an assessment of the quality of the contents, to understand the links between the documents cited and to determine to what extent they cover all aspects of internal control, given the absence of an explicit internal or external set of standards.

3.1.5 Risk assessment and management

Risk analysis is a critical part of any internal control system. The new Financial Security Act does not add any new provisions to the requirements already in place in this area. The AMF's instructions and recommendations for the last three years have asked that registration documents present detailed information about the main specific risks incurred by securities issuers.

Our analysis shows that 47 per cent of the companies in the sample described or named their main risk exposures in the chairman's report. In some cases, where the exposures are not mentioned in the chairman's report, they are dealt with in a special section of the registration document.

Most of the companies explain their risk assessment process. Risk mapping enables companies to evaluate their main exposures and present a summary of them in order of importance. Less than 15 per cent of the companies

mention such a process and when they do, 17 per cent of the companies only describe the general aspects of their risk mapping. Some companies explain that risks are ranked in order of their potential severity and frequency, without providing any other details.

Risk management, on the other hand, is intended to ensure that monitoring has been implemented for each of the strategic and operational risks identified so as to reduce the company's risk exposure to a level that it deems acceptable. The link between risk management procedures and the risks per se is rarely mentioned. The reports that do explain how risk management is organised often provide general information, such as mentioning that the company has a risk division and/or a risk committee. The level of detail varies greatly from a mere mention in most cases to a detailed description in a few cases.

The main risks described are market risk and credit risk, environmental risk, legal and tax risk, and the risks linked to protecting assets and industrial sites. In some cases, the reports present risks that are specific to the company's line of business, such as commodities risk, business conditions risk, counterparty risk, reinsurance risk, risk of incomplete turnover data, safety and security risks, IT risk, risk of error and fraud, reputation risk, and research and development risk.

3.1.6 Description of the general internal control environment

The quality of information about the control environment can be analysed from two angles: information about internal control players, which makes it possible to assess the quality of the existing system, or a presentation of the internal control structures and systems.

There are some good examples of reports with a special section dealing with internal control players. This section provides a brief description or ranking of each player. Three types of players intervene in internal control:

- control bodies: board of directors, audit committee, etc.
- management structures: management committee, executive committee, etc.;
- horizontal functions: legal department, administration and/or finance departments (including the management control department), information systems, risk management systems, etc.

New players are emerging in most groups as well:

- structures dealing with compliance and ethics (compliance officer or compliance department, ethics committee, conduct committee, etc.)
- internal audit departments/units/teams in 50 per cent of the companies in the sample, not all of the reports explain who belongs to the internal audit teams or what their remit is.

For example, on the last point, an analysis of the reports shows that there are major disparities in the human resources allocated to these areas, depending on the size of the securities issuers, their business areas and how well established the concept of internal audit is. Some medium-sized companies are only now setting up compliance units, which sometimes consist of a single person, such as the legal department head who works part time as an internal auditor. On the other hand, one French bank that has set up an internal audit and general control division that employs the equivalent of 850 full-time employees. Numerous internal audit structures were set up after the Financial Security Act was passed. Many companies are planning to increase their internal audit personnel very soon to carry out the usual internal audit duties, or to develop internal audit functions in their subsidiaries, or else to broaden the scope of internal auditors' activities.

Not all reports explain whom the internal audit teams report to. In the reports that do contain this information, most explain that the internal audit function reports to the group's senior management, or to its financial management or else to its audit committee.

Some reports show that the external auditors are considered to play a major role in internal audit. In the future, companies should be more specific about the role that external auditors play in the internal audit function, in order to avoid any ambiguity.

Three of the companies in the sample used a diagram or an organisation chart to supplement their descriptions, so as to overcome the difficulty of giving a written description of what are often complex systems and interactions between players. One of the groups in the CAC 40 stock index used an organisation chart to present its internal control function. One other medium-sized company also used charts to present the main operational players who carry out internal control tasks and another used charts to present the “*business flows and the various checkpoints*”.

The first reports show that actual internal control procedures concentrate primarily on:

- drafting and disseminating specific internal control procedure manuals for the various functions within the company: accounting and finance, management control, internal audit, sales, communications, marketing and human resources. The notion of drafting manuals is important because it shows that many companies had to provide official written descriptions of procedures that had not been used previously or had been transmitted by word of mouth.
- Self-assessment tools for internal control procedures which are used by the most advanced groups.

When it comes to fighting crimes, such as bribery, money laundering and insider trading, banks are in a singular position because of the nature of their business. They are legally required to have a special control environment, which may or may not be decentralised. For example, one bank group has given the task of internal control to each entity in the group, yet it still has a compliance department. One insurance company has assigned the task of fighting money laundering to the group’s compliance officer.

Some reports from manufacturing and service groups also discuss this topic. Two major groups explain that detecting and preventing embezzlement and fraud is the responsibility of the group’s general control unit.

3.1.7 Procedures relating to financial reporting

The procedures relating to financial reporting described by most companies relate to consolidation, management and reporting procedures.

To a lesser extent, the companies also describe procedures for monitoring off-balance sheet liabilities, assets and quality control for accounting and financial information.

Some companies’ reports also discussed other procedures, in addition to those cited in the market advisory group’s guidelines, including cash management procedures, budget procedures and investment procedures.

Less than half the companies provide any information about the different levels of accounting audits. On the other hand, virtually none of the companies state explicitly whether the procedures in subsidiaries are the same as those used in the parent company.

Two thirds of the companies provide information about the players involved in the control of the consolidation process (group finance department, decentralised finance departments, consolidation managers, group management control department, accounting teams, etc.), but less than half of them explain the links between the various players. About one third of the companies specify which software is used to store and transmit information.

Some companies go into greater detail, describing the links between vertical procedures for reporting data from a subsidiary or a division to the group and automated horizontal control procedures (consistency checks, reconciliation of management and financial accounts).

Companies also present other procedures, in keeping with their legal obligations. Those most frequently discussed include risk evaluation and management procedures, support function procedures (human resources, purchasing, marketing), operational, IT and legal control procedures, procedures for delegating authority, approving decisions and attributing tasks, procedures for ensuring personal, product and data safety, and quality procedures.

The reports do not have much to say about systems to promote preventive action, other than a little information about preventing insider trading or preventing fraud and errors.

3.1.8 Monitoring internal control

Some French companies seem to have a system for overall monitoring of their internal control procedures, a commitment to changing procedures and the ability to adapt and respond in the event of an anomaly, but they only discuss certain aspects of their systems in their reports. This issue is discussed in 58 per cent of the reports in the presentation of the special structures performing this task.

In reports that discuss this matter, the structures mentioned are, in decreasing order of frequency: the group internal audit department, the audit committee, the executive committee, the internal control committee, the monitoring department, the group general control division and subsidiaries' internal control departments.

Only 15 per cent of the reports provide an exact description of the internal control decision-making process, which means that, in almost all of the reports, it is difficult to understand what is involved in the task of internal control monitoring.

3.2 Due diligence and the directors' assessment of procedures

3.2.1 Due diligence performed in connection with the report

Less than a quarter of the companies mentioned the due diligence performed in connection with the chairman's report, such as interviews with senior executives, discussions at the board level, meetings with the external auditors and the audit committee, where applicable.

One company helpfully explains that *"this report was compiled with the help of the administration and finance department on the basis of the minutes of the meetings of the internal control committee. Work on this report was also helped by a meeting with the members of the board of directors' audit committee and a meeting on this subject with the external auditors. Even though the law requires that the chairman of the board submit this report, the board approved the contents at one of its meetings.*

The chairman of one CAC 40 company also notes that *"I requested that a special working group be set up to compile the report and that it be given direct access to all divisions and subsidiaries. Its task was to identify the existing control procedures and I personally supervised its work. The draft of the report was presented to an audit committee meeting [...] and it was presented and approved at the meeting of the board of directors held on [...]"*.

When companies provide details about the procedures used to compile their reports, they usually include: interviews with support functions, setting up special working groups or reviewing existing internal documents. Some companies explain that their internal audit function contributed to compiling the chairman's report. This contribution takes the form of participating in the working group set up to draft the report or even leading and coordinating the group's work.

Some companies also reported that exchanges of varying intensity took place with the external auditors and board committees and, more specifically, the audit committee, before and during the drafting of the report.

In future, it would be important for the shareholders to know whether such committees or the board itself were involved in drafting the report and to what extent.

3.2.2 Chairman's assessment of the adequacy of procedures

Ten of the companies in the sample explained that the ultimate objective of current and future work would be to achieve an assessment of the adequacy and effectiveness of their procedures and a handful of these companies have even set a timeframe for meeting these objectives.

The following examples are noteworthy, even though the assessments do not cover the entire internal control system:

- One company in the SBF 120 index explains that *"entities [...] accounting for some 80 per cent of the group's annual consolidated turnover evaluated their internal control systems using a self-assessment questionnaire reviewed by the auditors institute. The Audit Department [...] reviewed the soundness of the answers provided to the questionnaire. This system, which is a preliminary step in an evaluation process, did not reveal any problems likely to have a major impact on the company's finances or business.*

- One CAC 40 company that has to comply with the Sarbanes-Oxley Act²¹ explains that *“the procedures that the company established to manage accounting and financial information from the consolidated subsidiaries, as well as the internal control procedures used in compiling the consolidated financial statements are adequate to provide reliable accounting and financial information.”*

Other companies prefer to provide assessments of their internal control systems, explaining the weaknesses of internal control or areas for improvement.

For example, one SBF 120 company explains at the end of its report that *“risk monitoring tools are being implemented as part of a structured process in compliance with applicable standards in order to improve risk management. Accurate risk maps were drawn up and supplemented by key surveillance points. Improved operational incident analysis tools were implemented and the internal audit function’s recommendations were implemented.”*

The 2003 reviews and/or the plans of action described in the chairmen’s reports, especially when they contain little detail, are very revealing because they show the varying degrees of progress companies have made with regard to internal control. For the companies that have made an effort to achieve transparency in this area, we note that:

- Some companies are at the stage of organising and officialising their internal control system, which means establishing the administrative and financial procedures, defining the procedure for compiling consolidated financial statements, developing management software, identifying operational risks, discussing the appropriateness of setting up an audit committee or setting up an internal audit unit, appointing a compliance officer, disseminating an internal audit charter, setting up an internal control working group, etc.
- Other companies are at the stage where they are reinforcing their system: updating, strengthening or harmonising internal control procedures, compiling or updating self-assessment questionnaires so that each company in the group can evaluate the level of existing internal control against a defined list, drafting recommendations on best practices within the group’s companies, risk analysis and monitoring, proposals for improving risk management procedures, risk mapping, testing critical processes, strengthening the internal audit unit, etc.
- The companies that have made the most progress are starting a process that should result in an evaluation of their internal control system in the near future (updating the mapping of the group’s major exposures), but, in most cases, it only concerns the internal control with regard to financial reporting.

Several reports that specify areas for improvement stress compliance with the Sarbanes-Oxley Act²². One CAC 40 company explained, *“work on achieving compliance with the Sarbanes-Oxley Act is under way as part of plan that encompasses operational risk management. This work should be completed in 2005 at the latest”*.

It is a positive development that the internal control system is presented as a set of dynamic processes that changes as the group’s circumstances and objectives evolve. Most companies seem to be aware that it is an open-ended process that requires regular monitoring and review.

²¹ One CAC 40 company provided a loose translation of the report by the chairman of the executive board and the chief financial officer on control and procedures as defined by Section 302 of the Sarbanes-Oxley Act and presented in its 2003 Form 20F filed with the SEC. It reads: *“The chairman of the executive board and the group’s chief financial officer, having conducted an evaluation of the effectiveness of disclosure control and procedures, have concluded that they are effective”*.

“Internal control over financial reporting: no change or factor that is likely to affect our internal control over financial reporting occurred during the period under review or affected or is likely to materially affect our internal control over financial reporting.”

²² Companies listed on the New York Stock Exchange disclosed more than other companies about assessments of their internal control systems, because they will be required, starting in 2006, to make a judgment about the effectiveness of their internal control over financial reporting.

3.2.3 Identification of failures and material deficiencies in internal control

None of the reports examined mentions failures or material deficiencies in internal control.

Only two companies openly report two immaterial weaknesses.

- One company explains that the actions undertaken in 2003 “*revealed some weak points in internal control relating to certain administrative cycles. Remedial action was planned and included in the 2004 plan of action. These weaknesses are not deemed to be material internal control deficiencies*”.
- The other company discussed a specific point of compliance with group standards, reporting that following a special audit, “*no material anomalies were revealed in the operational units audited. However, the audit did identify some weaknesses in the application of methodology and a plan of action was launched to remedy them*”.

3.3 External auditors’ reports

All the French limited-liability companies in the sample have external auditors’ reports²³. Virtually all of the external auditors’ reports use the framework recommended by the CNCC.

The CNCC technical opinion dated 6 February 2004 called for auditors’ opinions to be qualified if the chairman’s report did not include an evaluation. Thus, the reports usually reported the following limitation of scope: “*While aware of the fact that this was the first financial year in which the new provisions introduced by Act 2002-706 of 1 August 2003 came into force and that there are no recognised practices relating to the contents of the report the chairman is required to draft, we note that this report does not include an assessment of the adequacy or effectiveness of internal control procedures relating to financial reporting*”.

The CNCC technical opinion dated 23 March 2004²⁴ incorporates the positions taken by the Chancery on 9 March 2004 (no assessment of the adequacy of procedures or their effectiveness) and the opinion handed down by the Haut Conseil du Commissariat aux Comptes (HCCC) on 4 March 2004. This means that the lack of an evaluation of the adequacy and effectiveness of internal control is no longer considered a scope limitation for the external auditor.

With the exceptions noted below, external auditors’ reports do not include observations²⁵ or qualifications concerning the information and statements that companies provide about internal control procedures relating to financial reporting.

Only two reports in our sample contained observations, which are reproduced below:

- “*The internal control procedures were substantially improved in 2003. However, not all of the procedures could be effectively implemented for the entire financial year.*”
- “*The information discussed in paragraph 2.4 [information on accounting and financial internal control procedures] and paragraph 2.5 [information on the procedure relating to financial reporting] should be documented more fully.*”

²³ As of this writing, the AMF has only received one report of a company failing to produce a chairman’s report.

²⁴ The CNCC technical opinion of 23 March 2004 cites three types of examples: an unqualified opinion (E1), a qualified opinion that cites the patent inconsistency of other information (E2) and an adverse opinion in the event that no chairman’s report is produced, or the chairman’s report does not give an account of internal control procedures relating to financial reporting (E3).

²⁵ The CAC standard stipulates that “*the external auditor’s observations on the information and the statements made in the chairman’s report, where applicable, about the internal control procedures relating to financial reporting shall concern the truthfulness and fairness of these statements. Therefore, the external auditor’s observations shall not concern the internal control procedures per se.*”

Furthermore, our overall review leads us to reveal the patent deficiency of the information about management of the main risk exposures.”

None of the reports mentions any deficiencies or material weaknesses in internal control that would have required the external auditors to notify the companies' senior management or board²⁶. The external auditors' task is to assess the fairness and reliability of the information, “but this does not mean a limited audit or analysis; instead it means ensuring the overall consistency of the information, its plausibility, given the circumstances, and its materiality...”²⁷. Thus, their reports do not enable us to draw distinctions between the chairmen's reports in terms of quality or the relevance of the information they provide.

The interviews reveal that the external auditors most frequent requests regarding the chairmen's reports were: more detail in sections that are too succinct (especially sections on internal control of accounting and financial information), a list of internal control objectives in reports where they are missing, explanation of the restrictions placed on the chief executive officer's powers in companies with boards of directors, elimination of “affirmations” about the proper operation of internal control without testing, and compliance with the guidelines set out by the AMF in January 2004. Furthermore, external auditors' assistance primarily concerned benchmarking to help companies determine whether the structure and contents of their chairmen's reports were in line with general practices.

²⁶ In his answer on 29 July 2004, the Minister of Justice carefully pointed out that “*even though it cannot be restricted to procedures relating to financial reporting alone, the chairman's report is also intended to provide the external auditors with a basis for further work on the evaluation of internal control that is part of the auditor's ongoing tasks and can cause the auditor to report material deficiencies discovered in internal control to the corporate bodies.*”

²⁷ From the CNCC technical opinion (§ 7.1. Nature and objective).

CONCLUSION

The AMF has already deemed that the Financial Security Act, which supplements existing provisions, has improved shareholder information and, more especially, it has led many of the players concerned to make an effort to organise and officialise their procedures. By encouraging companies to provide summary information about their governance rules and internal control procedures, the new Act provides an incentive for companies to review their existing systems, improve them over time and, where applicable, take measures to increase their effectiveness.

The review of listed companies' practices shows how eclectic industry practices are in these areas. Some companies had already taken the path of ongoing improvements to their procedures, without waiting until the new Act came into force. Other companies had to draw up specific plans for public disclosures about their existing systems, which often spurred them to amend and supplement their systems. Substantial in-house resources were used in many cases, both in terms of quantity and quality. The cost of the extra work, which few of the reports mention, should be offset by an improvement in the overall performance of the companies. The AMF welcomes the fact that so many companies seem to have understood the real value of the new requirement, in terms of better shareholder relations and improvements in their own organisation.

In formal terms, the reports produced are mostly preliminary presentations of the procedures in use. The immediate entry into force of the new Act meant that many companies did not have time to do more than document their existing systems. Therefore, the first set of chairmen's reports can be seen as a trial run in many cases. They are relatively uneven in both content and form. This means it is difficult to make comparisons between the reports, even between groups of similar size or in the same industry.

On the basis of the work companies have done in house, it would be better to see a gradual change, as companies evaluate their systems and ultimately achieve a properly prudent assessment of the reliability and quality of their systems. In the meantime, it is critical for securities issuers to provide material information to investors about their existing systems, their compliance with their own rules and planned changes.

In this respect, the remarks made in the main body of this report simply confirm and supplement the AMF guidelines published in January 2004. More specifically, it would be helpful for each company to report to shareholders on the due diligence performed in connection with the chairman's report and on the in-house resources used for this purpose. Similarly, the areas for improvement discussed by some companies with regard to the 2004 financial year often feature a comprehensive analysis and assessment process that is carried out in conjunction with outside consultants in some cases. It would be a good idea for the next chairmen's reports to cover progress made on this type of work, with a review of the action taken in 2004 and a plan of action for 2005.

Unlike corporate governance, where securities issuers can now measure themselves against market-wide standards, the lack of a universally accepted benchmark for internal control makes it more difficult to describe and could hamper efforts to achieve an assessment of the adequacy and effectiveness of systems. Some companies, especially those listed in the United States, have already adopted the COSO framework. Other companies are required to comply with standards applying to their industry. For the rest, the issue of a benchmark that is suited to the French legal and business environment can no longer be ignored.

Establishing such a benchmark could be a priority for the market as a whole. Once the industries concerned have validated and accepted these standards, they could constitute a set of benchmarks for evaluating the performance of organisations or individual processes. In addition to the main set of standards, more specific standards are bound to be required later to suit the special needs of certain industries or operational environments. A market-wide working group could be set up to establish a joint position on this matter and publish a recommendation endorsed by companies, regulators and auditors. This work could then be helpful as a basis for discussions with our partners in the European Union, as part of the process of drafting of new directives dealing with these matters.

APPENDIX I: Companies in our sample

Description of the sample

The analysis of disclosures by companies making public offerings of securities was made as of 30 September 2004 on the basis of the following sample:

- **118** reports, of which:
 - **104** selected from the registration documents identified by the AMF at that date (out of **340** registration documents filed as of that date for registration or after-the-fact supervision) and,
 - **14** selected from the reports posted to the AMF website as of that date (out of **33** reports posted to the website).
- 93 per cent of the companies in the sample issue shares that are traded on a regulated market, the rest issue bonds or shares that are traded on unofficial markets.
- 97 per cent of the securities issuers' head offices are in France. Of these, 95 per cent have been incorporated as limited-liability companies, 3 per cent are limited stock partnerships and 2 per cent are government-owned corporations.
- 31 per cent of the companies in the sample are in the CAC 40 stock index.
- 14 per cent²⁸ of the companies in the sample have to comply with the American Sarbanes-Oxley Act.

The sample was selected on the basis of different criteria:

- The CAC 40 companies were selected from those in the index as of 31 December 2003²⁹. The sample excluded companies with financial years that ended after 31 December 2003. Similarly, the sample excluded companies that had not published a registration document or posted a chairman's report to the AMF website as of 30 September 2004.
- Registration documents were selected by alphabetical order, regardless of the industrial sector or the size of the company, which ensured a very diverse sample.
- The reports that companies posted directly to the AMF website were selected in order of arrival, without any special selection criteria.

Companies in our sample

ACCOR
ACTEOS
ADL PARTNER
AGENCE FRANCAISE DE DEVELOPPEMENT
ALCATEL
APRIL GROUP
AREVA
ASSURANCES GENERALES DE FRANCE
ASSYSTEM BRIME
ATOS ORIGIN
AVENIR FINANCE
AVENTIS
AXA

BACOU-DALLOZ
BARBARA BUI
BNP-PARIBAS
BOIRON
BOLLORE
BOLLORE INVESTISSEMENT
BOURSORAMA
BOUYGUES
CAISSE DE REFINANCEMENT DE L'HABITAT
CAP GEMINI
CARPINIENNE DE PARTICIPATIONS
CARREFOUR
CASINO GUICHARD-PERRACHON

²⁸ Including 13 companies traded on the NYSE, 2 companies traded on NASDAQ and 1 company that belongs to a group where the parent company is traded on the NYSE.

²⁹ The report from Publicis Groupe SA, which later became part of the index, was already in the sample.

CAST
CDC IXIS CAPITAL MARKETS
CEGEDIM
CEGID
CEREP
CIC PARIS
CLIENT CENTER ALLIANCE
CNP ASSURANCES
COFITEM-COFIMUR
COHERIS
COIL
COMPAGNIE DE FINANCEMENT FONCIER
COMPAGNIE DE SAINT-GOBAIN
COMPAGNIE GENERALE DES ETAB. MICHELIN
CREDIT AGRICOLE S.A.
CREDIT COMMERCIAL DE FRANCE
CREDIT DU NORD
CYBERDECK
DASSAULT AVIATION
DASSAULT SYSTEMES
DEVOTEAM
DYNACTION
EADS N.V.
EGIDE
EIFFAGE
ESKER
ESSILOR INTERNATIONAL
EULER HERMES
EURAZEO
EUROPEAN CARGO SERVICES
EVIALIS
FAROS SA
FAURECIA
FEDON
FINATIS
FINAXA
FONCIERE DES PIMONTS
FONCIERE DES REGIONS

FONCIERE EURIS
FRANCE TELECOM
FRANCO BELGES PARTICIPATIONS
GALERIES LAFAYETTE
GAMELOFT
GECINA
GL EVENTS
GROUPE DANONE
GROUPE GASCOGNE

GROUPE OPEN
HAVAS
IDI
IEC PROFESSIONNEL MEDIA
IMERYS
INFOTEL
INITIATIVE ET FINANCE INVESTISSEMENT
INSTALLUX SA
INTER PARFUMS
IPSOS
JACQUET INDUSTRIES
JC DECAUX SA
JET MULTIMEDIA
KEYRUS
KLEPIERRE
LA POSTE
LA TETE DANS LES NUAGES
LAFARGE
LAGARDERE
L'AIR LIQUIDE
LAURENT-PERRIER
LEON DE BRUXELLES
LEXIBOOK
L'OREAL
LVMH MOET-HENNESSY-LOUIS VUITTON
NORD EST
PARTICIPEX
PERNOD-RICARD
PEUGEOT S.A.
PINAULT-PRINTEMPS-REDOUTE
PUBLICIS GROUPE SA
RENAULT
SANOFI -AVENTIS
SCHAEFFER DUFOUR
SCHNEIDER ELECTRIC
SOCIETE GENERALE
STMICROELECTRONICS N.V.
SUEZ
TELEVISION FRANCAISE 1
THALES
THOMSON
TOTAL S.A.
VEOLIA ENVIRONNEMENT
VINCI
VIVENDI UNIVERSAL

APPENDIX II: AMF GENERAL REGULATIONS

BOOK II ISSUERS AND FINANCIAL INFORMATION

TITLE II PERIODIC AND EVENT-DRIVEN DISCLOSURES

CHAPTER 1 PERIODIC DISCLOSURES

SECTION 2 INFORMATION ABOUT CORPORATE GOVERNANCE AND INTERNAL CONTROL

Article 221-6

Limited-liability companies issuing securities into the public shall publish the reports stipulated in the last paragraphs of Articles L. 225-37, L. 225-68 and L. 225-235 of the Commercial Code on or before the day the report stipulated in Article L. 225-100 of the Commercial Code is filed with the commercial court registry.

Other legal entities issuing securities into the public shall publish information relating to the matters stipulated in the last paragraphs of Articles L. 225-37 and L. 225-68 of the Commercial Code under the conditions mentioned in the first paragraph if they are required to file their financial statements with the commercial court registry, or as soon as the annual financial statements for the previous financial year have been approved, if they are not.

Article 221-7

The reports and information stipulated in Article 221-6 shall be disseminated as follows:

1° They shall be available for free consultation at the registered office of the legal entity and a copy shall be sent with no charge to any person who requests one.

2° An electronic version shall be posted to the AMF website and to the website of the legal entity, if it has website.

Article 221-8

If the securities issuer draws up a registration document in compliance with Articles 211-6 and 212-5, the said reference document shall include the reports and information stipulated in Article 221-6. In this case, the dissemination procedures stipulated in Article 221-6 shall not apply.