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AMF 2005 Report on Corporate Governance and Internal Control

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2005 AMF Report on information published by listed companies on corporate governance and internal control procedures

INTRODUCTION

This report was prepared in accordance with Article 122 *in fine* of the Financial Security Act [1], which requires the French securities regulator (Autorité des Marchés Financiers – AMF) to compile an annual report based on the information published by listed companies[2] on corporate governance and internal control.

1. Reminder of the French legislative and regulatory framework

Legislative framework

Financial Security Act. The Financial Security Act added Article L.621-18-3 to the Monetary and Financial Code. Under the new article, listed companies are required to disclose information on corporate governance and internal control procedures, in compliance with the General Regulation of the AMF. The AMF prepares its own report based on these disclosures.

The Commercial Code (as amended by the Financial Security Act) requires the chairman of the board of directors or the supervisory board of any listed limited-liability company to make an annual report to shareholders on "how the board prepares and organises its work 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, must also mention "any restrictions that the board of directors has placed on the powers of the chief executive officer"[3].

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 statutory auditors' report does not contain any observations about other internal control procedures or about the information provided on corporate governance practices (Article 120).

Economic Confidence and Modernisation Act. The Economic Confidence and Modernisation Act of 26 July 2005[4] (the Breton Act) modified these requirements.

Under the new legislation, only listed limited-liability companies (*sociétés anonymes*) are required to make an annual report to shareholders on corporate governance and internal control procedures. This measure offered a response to widespread calls from the business community since the Financial Security Act's introduction[5]. The new act did not modify the scope of the requirement to publish this information, as set down in the Monetary and Financial Code.[6]

The Breton Act also strengthened the rules on directors' remuneration by modifying the framework for granting remuneration packages and by enhancing shareholder disclosures on directors' pay.

In this context, the act amended the Commercial Code. Now, if the director of a company whose securities are admitted to trading on a regulated market leaves his position or if his functions change, any remuneration, compensation and benefit commitments made to him by the company in this regard must comply with the rules on related party agreements. Directors include the chairman and chief executive officer (CEO), the CEO, the deputy

[1] Act 2003-706 of 1 August 2003, published in the Official Journal of 2 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 (adding Article L.621-18-3 to the Monetary and Financial Code).

[2] This term is used here to mean public companies, i.e., any company which has made a public offering of its securities.

[3] Article 117 of the Financial Security Act.

[4] Act 2005-842 of 26 July 2005, published in the Official Journal of 27 July 2005.

[5] Under the Financial Security Act, the obligation to report to shareholders applied to all limited-liability companies.

[6] Note that the publishing requirements apply to all companies making public offers of securities, including limited stock partnerships and foreign companies.

CEO, and members of the executive board in companies with an executive board and a supervisory board[7]. This amendment has lifted the uncertainties surrounding deferred compensation for directors (unilateral decision by the board or related party agreements) and created a single regime for the different remuneration packages made available to directors, which include perks, stock options, golden parachutes and supplementary pension schemes.

The Breton Act also enhanced disclosures to shareholders on corporate officers' pay, by requiring management reports to describe:

- the fixed, variable and exceptional portions of directors' remuneration and benefits, with a breakdown of these components plus the criteria used to calculate them or the circumstances under which they were granted;
- commitments of any sort made by the company on behalf of corporate officers with respect to remuneration, compensation or benefits due or likely to come due when the individual in question begins or ceases to perform the stipulated functions or takes up different functions, or after such events have taken place. The report is required to specify the procedures used to calculate these commitments[8].

In addition, the Breton Act requires statutory auditors to make a separate entry in their report attesting that the information in the management report concerning directors' remuneration is true and accurate[9].

Takeover Act. Parliament[10] is currently debating a bill that would transpose the European Takeover Directive of 21 April 2004[11]. The new legislation is supposed to come into effect when the implementation deadline expires, i.e. on 20 May 2006 at the latest. The bill includes provisions to strengthen shareholders' rights during the offer period.

During the offer period, directors will be obliged to consult shareholders before taking any steps that could frustrate a bid (Art. 10 of the bill). Furthermore, any authorisations previously granted to directors for this purpose are suspended during the offer period. Also, if a defence measure of this kind was decided on before the beginning of the offer period but not completely implemented, it will have to be approved or confirmed by shareholders[12].

The bill also extends the list of information that could have a bearing on a takeover bid and must therefore be mentioned in the management report, including powers of directors, changes in control, securities with special rights, restrictions on voting rights, and rules for appointing and replacing directors.

Furthermore, if a bid is submitted, the directors of the companies in question must convene "their respective works councils immediately to inform them of the bid". The offeree's works council then decides whether to hold a hearing with the offeror and may also indicate whether the bid is hostile or friendly. The offeror's directors must provide the offeree's works council with a copy of the bid prospectus within three days of its publication[13].

Besides the issue of takeovers, the bill also modifies the rule – introduced into the Commercial Code by the Financial Security Act – that decisions taken at shareholder meetings are null and void if the provisions for electronic voting are breached[14]. The legislative change reflects the recommendations of the report on the exercise of shareholder voting rights[15] prepared by the working group set up by the AMF and led by Yves Mansion. The report found that automatic

[7] Art. 8 of the Breton Act, amending Articles L. 225-42, L. 225-90, L. 225-22 and L. 225-79 of the Commercial Code.
[8] Art. 9 of the Breton Act, amending Article L. 225-102-1 of the Commercial Code.
[9] Art. 9 of the Breton Act, amending Article L. 225-235 of the Commercial Code.
[10] The draft legislation has been adopted by the Senate and is scheduled to be brought before the National Assembly in December 2005.
[11] Official Journal of the European Union No. L 142 p. 12s.
[12] The bill therefore repeals Article L.225-129-3 of the Commercial Code, which states that "any delegation made by the general meeting is suspended while a takeover bid or exchange offer for the company's securities is in progress, unless it forms part of the company's normal business activities and its implementation is not liable to cause the offer to fail".
[13] Article 7 of the bill, which extends Article L. 432-1 of the Labour Code.
[14] Article L. 235-2-1 of the Commercial Code.
[15] Report on the exercise of shareholder voting rights, AMF Monthly Review, No. 17, September 2005. Cf. p. 37,

nullity rules had stymied the growth of electronic voting by making companies reluctant to use this inexpensive voting approach for fear that all the decisions taken at a given meeting could be cancelled in the event of disputes over shareholder identity. Making nullity non-automatic[16] should promote the spread of electronic voting.

In October 2005, the AMF organised a consultation on the working group's recommendations, some of which may well lead to other legislative and regulatory amendments.

Also, following on from a public consultation by the European Commission, European-level talks are set to begin in 2006 on a proposal for a directive to facilitate cross-border voting.

Regulatory framework

In accordance with Article 122 of the Financial Security Act, the AMF General Regulation sets the rules for publishing information on corporate governance and internal control. These rules appear in Articles 221-6 to 221-8 of the AMF General Regulation.

The AMF has also explained what it expects in terms of the content of companies' disclosures on corporate governance and internal control[17].

It has called on companies to follow the guidelines released by industry bodies on the principles and procedures for preparing the chairman's report, and in particular the section on internal control procedures. The guidelines are in a joint document published by the French Association of Private Companies (Association Française des Entreprises Privées – AFEP) and the French Business Confederation (Mouvement des Entreprises de France – MEDEF)[18] and in the legal memorandum published by the National Association of Joint-Stock Companies (Association Nationale des Sociétés par Actions – ANSA)[19].

In the same recommendation, the AMF provided additional guidance on corporate governance and internal control.

Furthermore, the supervisory authority for the audit industry (Haut Conseil du Commissariat aux Comptes – HCCC) is currently examining a new standard on the content of the auditors' report on the chairman's report, with a view to its approval by the Minister for Justice[20].

Corporate governance. In its 2003 and 2004 recommendations on drafting registration documents[21], the AMF referred to the reports by market advisory groups on corporate governance[22], calling on listed companies to "provide a transparent description of the corporate governance rules that they follow". Further, the AMF asked companies to say which recommendations they had implemented and to explain, where applicable, why they had not followed other recommendations.

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which deals with internet voting ahead of shareholder meetings.

16 Article 22 of the bill, which was introduced by a Senate amendment, extends Article L. 235-2-1 of the Commercial Code. It states that a judge may rule that a decision is not null and void if an incident disrupts electronic voting but has no impact on the adoption or rejection of proposals. Before they can benefit from this exception to the nullity rules, companies must prove that they have deployed the resources necessary to identify shareholders, enable participation and ensure voting integrity.

17 Corporate Governance and Internal Control – Disclosure and Publication Requirements for Listed Companies, AMF Monthly Review, March 2004, No. 1, p. 39s (in French).

18 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".

19 Memorandum No. 3267 of 5 November 2003 prepared by ANSA's Legal Affairs Committee.

20 Currently, auditor reports are prepared in accordance with a technical opinion by the National Statutory Auditors' Institute (Compagnie Nationale des Commissaires aux Comptes – CNCC), dated 23 March 2004.

21 COB Monthly Bulletin, January 2003, No. 375, p. 17s and AMF Monthly Review, March 2004, No. 1, p. 39 s.

22 These recommendations are found in the joint AFEP/MEDEF reports, also called the Viénot Report of July 1995 and the Bouton Report of September 2002. These reports have been consolidated in a joint AFEP/MEDEF document entitled "Corporate Governance for Listed Companies" published in October 2003.

In its January 2004 recommendation[23] and in its first report on information published by companies pursuant to the Financial Security Act[24], the AMF extended this guidance to include all listed companies. It also ruled that the question of "how boards prepare and organise their work" could be considered to come under the heading of corporate governance, since all the recommendations in the AFEP/MEDEF report deal with the way in which boards of directors prepare and organise their work.

Internal control. The AMF said that reports prepared by listed companies should include information with market relevance, and not just descriptive details. In its January 2004 recommendation, the AMF therefore asked companies to give details of the due diligence performed in connection with their reports, such as interviews with senior executives, discussions at the board level, meetings with the statutory auditors and the audit committee, where applicable.

The AMF also reminded companies of two obligations that had to be met in the context of preparing these reports.

First, statutory auditors have an obligation to report any problems encountered during an audit to the corporate bodies, including any material deficiencies discovered in internal control procedures[25]. The AMF recommends that the company's report should mention such shortcomings.

Second, market regulations already 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 a material failure or shortcoming in internal control identified in the assessment process or in the due diligence performed in connection with the report[26].

In addition, the AMF said it wanted this approach to be part of a dynamic process that would ultimately enable companies to assess the adequacy and effectiveness of their internal control systems. Accordingly, it encouraged companies that had already assessed their internal control procedures in the previous year to include a summary in their report, mentioning any planned strategies for improvement.

The AMF urges companies to keep these recommendations in mind as they prepare their reports on FY2005.

Furthermore, in its 2004 report, the AMF said that internal control assessments, while desirable in the long run, were hindered by the lack of a common set of standards. It therefore set up a market advisory group to prepare a set of internal control standards for use by French companies subject to the requirements of the Financial Security Act.

The standards would be designed as a tool for use by companies making public offers of securities. They should also promote greater uniformity in internal control reports, making them clearer to investors. The project is slated for completion before the end of first-half 2006.

The standards should be compared against those in effect in other leading financial centres, notably the COSO standards, to avoid duplicating internal control disclosure requirements, especially for companies that are also listed in the USA.

The above provisions and recommendations also apply to reports on FY2005.

2. International environment

Implementing Sarbanes-Oxley

[23] Corporate Governance and Internal Control – Disclosure and Publication Requirements for Listed Companies, AMF Monthly Review, March 2004, No. 1, p. 39s.
[24] AMF Monthly Review, No. 10, January 2005, p. 43s.
[25] CNCC Standard 2-107.
[26] Article 222-3 of the AMF General Regulation. Listed companies must also disclose any findings of an internal control evaluation that reveals a possible impact on the company's or the group's financial situation.

In the United States, the provisions in section 404 of the Sarbanes-Oxley Act on the deadline for compliance with internal control disclosure requirements have been relaxed[27]. The Securities and Exchange Commission (SEC) said in press release on 21 September 2005 that it would give an extra year to issuers, including non-US companies, with a free float of under USD 75 million. They will be required to comply with section 404 for financial years ending after 15 July 2007. Other issuers have until 15 July 2006.

Modifications to European Directives

Prospectus and Transparency Directives. The Implementing Regulation[28] of the Prospectus Directive[29], transposed into French law by the Breton Act and the AMF General Regulation (which came into force in September 2005), requires companies to disclose their corporate governance procedures. The Breton Act also transposes some provisions of the Transparency Directive[30], which requires the responsible individuals to make statements to the effect that the annual and interim financial statements and management reports represent a true and fair view of the company's situation. Next year, the AMF General Regulation is going to clarify the content of these new obligations, which have to be implemented by 20 January 2007 at the latest[31].

Fourth and Seventh Accounting Directives. As part of its plan to move forward on "modernising company law and enhancing corporate governance in the European Union"[32], the European Commission has published proposals to modify the Fourth and Seventh Accounting Directives. On 20 December of last year, the Commission released a consultation paper aimed at reviewing the action plan so as to review existing measures and identify Commission priorities in the area.

Proposed amendments include introducing a statement on corporate governance, internal control and risk management as part of the financial reporting process for companies registered in Europe whose securities are traded on a regulated market.

Companies would be required to include their corporate governance statement as a separate and easily identifiable part of the management report. The Directive stipulates the minimum content requirements for these statements.

As a minimum, all EU listed companies would have to provide shareholders with information about how corporate governance is organised, indicate whether the firm has introduced a corporate governance code, either voluntarily or because it was obliged to, and say whether it applies provisions that go beyond those required under national laws. Companies that follow a corporate governance code, voluntarily or not, are required to take an "comply or explain" approach.

The European Parliament adopted the draft on 15 December 2005 at first reading.

Eighth Directive. The Council reached political agreement on the proposed Eighth European Directive on statutory audit after the European Parliament adopted the proposals in late September. Under the proposal, public interest entities[33] must have an audit committee whose tasks will include tracking the financial reporting process and

[27] The Act requires an assessment of internal control over accounting and financial issues, under the responsibility of the chief executive officer and the chief financial officer.

[28] Regulation EC 809/2004 of 29 April 2004, Official Journal of the European Union L 149, p.1s. Cf. in particular points 14 to 16 of the schedule for share registration documents in Annex I of the Regulation.

[29] Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading, Official Journal of the European Union L 345, p.64s.

[30] Directive 2004/109 of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Official Journal of the European Union L 390, p. 38s.

[31] The legislative component of the transposition was inserted into the Breton Act. However, some of the provisions will not come into effect until 20 January 2007, which is the deadline for transposition.

[32] Commission Communication adopted on 21 May 2003, COM(2003) 284 final.

[33] The concept of public interest entities was discussed and developed as part the work done on statutory audits by the EU Committee on Auditing. Article 2 of the Directive provides a definition for this type of entity. Public interest entities include entities

monitoring the effectiveness of the company's internal control, internal audit (where applicable) and risk management systems.

This position of principle notwithstanding, audit committees are unlikely to become widespread across all EU Member States because the Directive stipulates that Member States may allow the functions of the audit committee to be performed by the entity's main administrative or supervisory body. Member States will also be free to decide whether the audit committee should be made up of non-executive members of the administrative body and/or of members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee should be independent and have competence in accounting and/or auditing.

Member States shall ensure that the statutory auditors or audit firms carrying out statutory audits for public interest entities provide an annual statement to the audit committee confirming their independence with respect to the audited entity, disclose additional services provided to the audited entity, and discuss with the audit committee threats to their independence and the safeguards applied to mitigate those threats.

The statutory auditors shall report to the audit committee on key issues arising from the audit, and especially on material weaknesses in internal control in relation to the financial reporting process.

Non-binding rules

European Commission recommendations. As part of its 2003 action plan, the European Commission published two recommendations on corporate governance for listed companies. The first, dated 14 December 2004, dealt with the remuneration of directors of listed companies. Among other things, it recommended that shareholders be provided with information on the company's remuneration policy and on the individual remuneration packages of directors. The second, dated 15 February 2005, concerned the role of non-executive or supervisory directors of listed companies and on the committees of the supervisory board. It provides a definition for non-executive and independent directors, stating that "a director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement". Member States are also required to adopt a number of criteria at the national level to assess the independence of directors, taking into account the guidance provided by the Commission. The Commission also recommends that companies create audit, nomination and remuneration committees, but leaves open the possibility of grouping these functions into fewer than three committees. Furthermore, the Commission recommends that the supervisory board be evaluated.

Given the complexity of these issues and differences in national practices, the Commission decided to take a recommendations-based approach, to give Member States the flexibility needed to apply the associated principles. Member States have been invited to take the necessary measures to promote the application of the principles set out in the recommendations by 30 June 2006, and to notify the Commission of steps taken in this regard so that it can assess the need for further measures.

OECD and IOSCO. In April 2004, the Organisation for Economic Cooperation and Development (OECD) amended its corporate governance principles, which constitute a charter endorsed by all the OECD countries. In 2005, the OECD introduced a methodology to assess Member States' corporate governance systems, with a view to determining how the OECD principles are being put into practice.

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that have significant public relevance because of the nature or size of the business, or the number of people employed. Companies whose securities are admitted to trading on a regulated market, banks and insurance undertakings are considered to be public interest entities.

In late October 2005, the International Organization of Securities Commissions (IOSCO) and the OECD set up a joint working group to consider application of principle VI, point E of the OECD corporate governance principles on "objective independent judgement" of the board, which deals with the question of independent directors, and to explore ways to protect minority shareholders.

1. METHODOLOGY AND INITIAL FINDINGS ON ENFORCEMENT OF LAWS AND REGULATIONS

1.1. Methodology

The purpose of this report is to gauge the relevance of corporate governance and internal control disclosures by companies making public offers of securities. The report is based on a documentary analysis and a series of informal interviews (see below).

1.1.1 About the sample

The following analysis of disclosures by companies making public offers of securities was made as of 30 October 2005 on a sample of 108 reports. A list of the companies in the sample can be found in Appendix I. As with last year's sample, the AMF examined all the companies in the CAC 40 index at 31 December 2004, but also made a point of considering a range of other firms representing all sizes and sectors, including companies on the Marché Libre and foreign companies.

1.1.2 Methodology for analysing reports

The AMF prepared a checklist for the main areas covered in the industry recommendations on corporate governance and internal control and used it as the basis for a statistical analysis of the contents of reports filed by sample companies.

1.1.3 Interviews with companies and statutory auditors

The AMF wanted to supplement its analysis of documents with face-to-face meetings with a number of listed companies and statutory auditors[34]. This process, which focused on the practical experience of the players concerned, was designed to gain a better understanding of the work companies have done to improve corporate governance and internal control, to gain an insight into the methods they use to document, test and assess the effectiveness of their procedures, and to learn about any difficulties encountered along the way. The interviews were conducted in Autumn 2005.

Interviewees were asked about a range of subjects, including the scope of reports, problems encountered by companies during the drafting process, the main comments by statutory auditors in this regard, companies' objectives for 2005 (e.g. in terms of risk mapping and procedures for assessing internal control), their thoughts on legal and regulatory requirements, the role of senior managers and statutory auditors, and their position on the French standards currently being prepared by the market advisory group.

1.1.4 Other research published in this area

In addition to its own work, the AMF monitored other publications and events that dealt with corporate governance proposals. The French Institute of Company Directors (Institut Français des Administrateurs – IFA) released its new recommendations on 19 October 2005. Also in Autumn 2005, the AMF working group chaired by Yves Mansion on voting at shareholder meetings published its proposals, and several organisations issued the findings of their corporate governance reviews.

1.2 Compliance with disclosure rules

At 30 October 2005, all bar one of the registration documents analysed by the AMF contained a report from the chairman or information on the subjects stipulated in Article 117 of the Financial Security Act. Also, statutory auditors' reports were supplied for all French limited-liability companies.

[34] To conduct these interviews, the AMF selected a few representative companies, including one mid-sized French firm from the industrial sector, one large French industrial firm, a foreign company, an issuer listed in the USA and a French company from the banking sector. The AMF also met with some of the main audit firms that provide statutory auditing services to listed companies.

The AMF found that in 2004, 280 companies whose securities were admitted to trading on Eurolist had failed to meet the requirement to disclose information on corporate governance and internal control.

These included five companies in Eurolist's Segment A (three of which were eligible for the deferred settlement facility, or SRD), 38 in Segment B (four eligible for the SRD), 130 in Segment C, 84 in the Foreign Stocks Segment (11 eligible for the SRD) and four in the special section[35].

The AMF found that once again many companies failed to comply with their statutory disclosure requirements. Note that the AMF will post online the names of companies that fail to meet the requirement to publish a report on corporate governance and internal control[36]. The list will reflect the publication gaps detected when this report was compiled.

1.3 Inclusion of reports in registration documents

Following the AMF's January 2004 recommendation, almost all the sample companies included their corporate governance and internal control reports in their registration document. Indeed, of all the companies that published a registration document, only one did not append its corporate governance and internal control report.

In terms of format, the report typically appeared in a separate section of the registration document or in the notes, in which case it was followed by the statutory auditor's report. Some companies printed the report in the notes but also included part of it in the corporate governance chapter of the registration document, potentially leading to unnecessary repetition.

Large companies in the banking and finance sector provided detailed descriptions of the risks that their internal control systems are designed to manage. Other companies made no connection between the risks listed in the "risk factors" section and those that the internal control procedures are supposed to address (cf. 3.1.4).

The AMF wishes to reiterate that corporate governance and internal control reports should be presented in a clear format. Furthermore, if the content of the report is spread across several sections of the registration document, this should be clearly indicated by including cross-references within the body of the report. Companies submitting their registration document as an annual report should adjust the concordance table to take this requirement into account.

The AMF General Regulation and its implementing instructions have been amended with the entry into force of the Prospectus Directive. New models for prospectuses and registration documents are now applicable. Companies publishing a registration document must include details of their internal control system in the corporate governance chapter of that document[37]. By doing so, they will satisfy their disclosure requirements in this area.

[35] According to a Euronext Notice dated 8 February 2005, Segment A holds companies with market capitalisation of over €1 billion, Segment B is for market caps between €150 million and €1 billion, while Segment C has market caps of under €150 million. The Special Box includes the former Nouveau Marché special section as well as companies from other segments that are subject to collective proceedings.

[36] 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 in the Legal Gazette (Bulletin des annonces légales obligatoires – BALO) as required by law.

[37] Art. 221-8 of the General Regulation.

2. CORPORATE GOVERNANCE

2.1 How boards prepare and organise their work

2.1.1 Board organisation

Composition of the board of directors

General information about directors. In all, 77% of the sample companies had a board of directors, while 21% had a supervisory board and an executive board.

Almost all the companies in the sample provided clear information on the composition of their board: 95% gave the names and number of directors, 60% said how old directors were, and 81% indicated the length of appointments. Other directorships outside the company were also disclosed.

On average, companies in the sample had 10.5 board members.

Furthermore, 19% of the sample companies provided information on the educational background of their directors. In such cases, the leading French institutions – HEC, Institut d'Etudes Politiques, Polytechnique – were well represented. There was also a strong international presence, in the shape of non-French directors and directors who had attended foreign institutions

Independent directors. A full 76% of the companies in the sample (95% of CAC 40 companies) said that their board had one or more independent directors. Independent directors accounted for around 46% of all the board members of the sample companies.

Companies did not always explain the criteria for being an independent director. Note that the AFEP/MEDEF report provides a definition in this regard, which is included in Appendix II of this report.

Some 59% of the reports referred to a definition for independent directors. In 78% of cases, this was the AFEP/MEDEF definition. Some companies mentioned this definition, but stipulated that the board had final say over whether a director qualified as independent. For this reason, some directors were described as independent although they did not meet the AFEP/MEDEF criteria.

The 22% of companies that did not use the AFEP/MEDEF criteria either used an in-house definition or followed the NYSE or NASD definitions used in the USA.

The AMF reminds companies that they should say what definition of independence they are using when they supply information on the independence of directors.

Multiple directorships. 80% of companies in the sample provided information on the number and types of other directorships held by members of the board of directors.

The boards of the sample companies were evenly split between members holding zero to five other directorships and members with over five directorships.

The information provided in this regard does not tell readers whether companies are complying with Article L. 225-21 of the Commercial Code, which states that individuals may not hold directorships with more than five French limited-liability companies. For the purposes of the article, directorships with group companies do not count, and directorships with unlisted companies count as one directorship. So for shareholders to be confident that the law is being respected, companies must say whether additional directorships are with French limited-liability companies, foreign firms, group companies, non-group companies, or companies whose securities are not admitted to trading on a regulated market.

The AMF recommends that companies disclose the nature of other directorships held by their directors, indicating for example whether these positions are with group companies, foreign companies or unlisted companies.

The role of the board

Some 67% of the reports analysed gave a precise definition of the board's tasks, compared with 40% last year.

The main tasks cited included examining the financial statements, approving the annual budget, discussing strategy, appointing corporate officers and, where applicable, considering committee reports.

2.1.2 Operation of the board and its committees

Board meetings

All the reports analysed said how many times the board met. On average, the boards of sample companies met 6.6 times a year.

Moreover, 78% of the reports gave director attendance rates, which averaged 86%. Also, 67% of the reports gave details of the information provided to directors ahead of meetings. Generally, directors received information one week in advance. However, these overall results mask differences in the quality of information provided to directors. Some companies, for example, organised seminars lasting several days to raise board members' awareness of particular issues. Others merely reported that their directors had been provided with "the documentation needed to perform their duties".

A total 71% of reports provided Information on issues raised at board meetings, up from 50% last year. The main subject areas covered included the transition to International Financial Reporting Standards (IFRS), reviewing and approving the financial statements, corporate actions, restructuring efforts, company strategy, supervision of committee work, and remuneration arrangements for directors and senior managers. To draw a clear distinction between the tasks of the board and the issues covered in meetings, some companies provided a breakdown of the subjects discussed by directors, sometimes providing details on each individual meeting.

In all, 53% of the reports included a review of the board's activities.

Rules of procedure

Of the companies in the sample, 56% (90% in the case of CAC 40 companies) said that their board was subject to rules of procedure, and three-quarters of these companies gave details of the areas covered by the rules. In 20% of cases, companies said that these rules were available to the public.

In all, 20% of the reports analysed indicated that the rules were amended in 2004. This relatively low percentage can be attributed to the fact that many firms modified their rules in 2003, notably to accommodate the recommendations of the AFEP/MEDEF report.

If the board is subject to rules of procedure, the AMF recommends that companies make these rules public, publish a summary or say where they can be consulted.

Specialised committees

Some 76% of the companies in the sample reported that they had specialised accounts, remuneration and appointments committees, in keeping with the AFEP/MEDEF corporate governance principles. This is broadly unchanged from the 75% recorded in 2003.

Details of how the board of directors or the supervisory board interacted with its committees were provided in 68% of the reports analysed. Most of the reports said that the board had a strong influence on committees, mainly in terms of appointing members and supervising activities. Around one-third of reports indicated that some tasks were delegated to committees, but mostly the board of directors or the supervisory board dealt with the statutory auditors either directly (20%) or indirectly via the audit or accounts committee (50%). Some sample companies also referred to dealings with shareholders and senior management.

Audit/accounts committee. Of the sample companies, 68% had an audit or accounts committee, compared with all the companies in the CAC 40.

Almost all the reports provided a precise description of the composition of the audit/accounts committee, including the number of independent directors, the educational background of committee members, and the committee's main tasks. Audit/accounts committees had an average of four members. Typically, these committees were assigned to review the annual and interim accounts and accounting methods, select statutory auditors, monitor risks and examine internal control procedures.

Just over half the reports supplied a detailed description of how the audit committee functioned. Around two-thirds included a review of the committee‘s activities.

One-half of the companies in the sample provided information on the relationship between the audit committee and the statutory auditors. Audit committees typically supervised the auditors, although they were often involved in selecting and assessing auditors too.

One-third of the reports described the role of the audit committee in preparing the internal control report, which ranged from analysing the chairman's report to supervising the process. In some cases, this included making a report to the chairman and formulating recommendations.

Remuneration and/or appointments committee. Of the 76% of sample companies that said they had set up specialised committees, 67% had a remuneration committee, which was merged with the appointments committee in 43% of cases.

A full 93% of the companies that had such committees described their make-up and assignments. However, less than one-half supplied information on how the committees functioned and under two-thirds included a review of the committee's activities.

Remuneration and appointments committees had an average of three members. They were usually tasked with devising the remuneration policy for members of the board of directors / supervisory board and senior management. Depending on the company, the committee was more or less involved in selecting and appointing directors and senior managers.

2.1.3 Performance assessment of the board and/or specialised committees

In all, 37% of the companies in the sample assessed the performance of their boards, compared with just under a quarter last year. In around 80% of cases, these assessments were internal, with external assessors involved in the other 20% or so of cases. Two companies said they had conducted both in-house and external assessments. Of the companies that did assess performance, 75% said they did so on an annual basis.

Just 20% of companies disclosed the results of these assessments. Meanwhile, 22% of companies mentioned ways in which they planned to improve the way the board functioned, for example by clarifying arrangements for holding meetings, organising more meetings with senior managers, and providing training for directors. Some companies, seeing this area as key to the success of their business, positioned themselves within an ongoing process, describing improvements introduced over the course of the year.

Whether or not they conducted an official evaluation, 24% of companies in the sample assessed the input of their directors.

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

Some 71% of companies with boards of directors (which comprised 76% of the overall sample) provided information on restrictions placed by the board on the CEO's powers, compared with 30% in 2003. Companies are therefore showing greater transparency on this issue, almost certainly in response to the AMF's recommendation in last year's report. Accordingly, the AMF wishes to reiterate this recommendation, to encourage companies to enhance their disclosure of restrictions on the CEO's powers.

Looking at disclosures made in this regard, some companies used the stock phrase: "aside from legal and regulatory restrictions, the board placed no restrictions on the powers of the chief executive". Others provided a detailed list of transactions requiring board approval, where appropriate referring back to the relevant rules of procedure and bylaws.

The AMF once again recommends that reports describe 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 were these restrictions are official, the report could refer readers to the company's rules of procedure, if these have been published.

3. INTERNAL CONTROL PROCEDURES

3.1 Description of internal control procedures

3.1.1 Scope of reports

Some 80% of the companies in the sample defined the scope covered by their report, and 62% explained which subsidiaries were included. All the reports analysed said that internal control encompassed internal control procedures aimed at ensuring the accuracy of the accounting and financial consolidation process. A further 63% referred to procedures to ensure compliance with laws and regulations, while 81% said that operational control was included.

Just 32% of the sample companies complied with last year's recommendation to separate group procedures from those of certain subsidiaries and to describe any planned measures. Accordingly, the AMF renews this recommendation for companies preparing their 2005 reports.

Virtually all of the reports contained a special section on internal control procedures relating to financial reporting. This format is in line with the wishes of the CNCC[38] and the AFEP/MEDEF recommendation on chairmen's reports, insofar as statutory auditors' reports are required to present observations on this information only.

The AMF once again recommends that information on internal control procedures should always be provided at group level. The report should clearly indicate any differences between the group system and the internal control procedures used by large subsidiaries. The AMF also recommends that companies indicate any future plans in this area, e.g. whether they intend to continue using different systems, planned measures, etc.

3.1.2 Internal control definitions and objectives

Companies can choose from a range of definitions provided by industry bodies, including the AFEP/MEDEF[39], COSO[40], the CNCC[41], and the Institute of Internal Auditors (IIA) / Institut Français de l'Audit et du Contrôle Internes (IFACI)[42].

These definitions are based essentially on the objectives of internal control. As a result, most companies – 94% of the sample – described the objectives of their internal control system.

Just 58% referred to the inherent limitations of internal control procedures and usually talked in general terms, often singling out the human factor.

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[38] CNCC technical opinion 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".

[39] The AFEP and MEDEF say 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 with the company's internal values, standards and rules, and to ensure 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".

[40] 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".

[41] For the CNCC, internal control procedures involve complying with management policies, safeguarding assets, preventing and detecting fraud, ensuring accuracy and completeness of accounting records and the timely production of reliable accounting and financial information (CNCC Standard 2-301 on Risk Evaluation and Internal Control, § 08, CNCC Reference Framework, July 2003).

[42] IIA /IFACI Standard 2120-A1 states that, based on the findings of the risk evaluation, internal audit should assess the relevance and effectiveness of the internal control system for the organisation's corporate governance, operations and information systems. The assessment should cover the reliability and integrity of financial and operational reporting, operational efficiency and effectiveness, protection of assets, and compliance with laws, regulations and contracts.

Pending the release of standards in this area, the AMF recommends that companies specify the objectives and limitations of internal control in their business, rather than merely discussing these aspects in theoretical or general terms.

3.1.3 Standards used

In all, 33% of the sample companies indicated which set of standards they used to compile their report. In 86% of cases, companies said they used in-house standards based largely on the COSO standards. Under 5% of the sample made explicit reference to other industry standards by organisations like the IIA and IFACI.

Some 18% of sample companies said they used standards that were required under prudential rules for at least part of their business.

A market advisory group has been set up to propose a set of standards that is tailored to the French legal environment, for use by French companies. Pending the outcome of this project, companies should indicate which standards they used as a basis for their report.

3.1.4 Risk assessment and management

A total 68% of sample companies described their main risk exposures, compared with 47% last year. However, only 58% of the companies in the sample provided detailed information on these risks.

Given that internal control procedures are most effective when based on a risk assessment, which only the company can perform, the AMF recommends that companies demonstrate the link between this assessment, which usually appears in the “risk factors” section of the registration document, and their risk management procedures

3.1.5 Description of internal control procedures

A full 87% of the companies in the sample described their internal control procedures, while 75% specified the degree to which these procedures have been made official. Internal control procedures tended to be documented in a range of formats, including internal control handbooks and guides, administrative and financial handbooks, codes of business ethics and codes of conduct.

Procedures relating to financial reporting. 90% of the companies in the sample provided detailed information on their internal control procedures for financial reporting.

Other internal control procedures. Under the Financial Security Act, internal control is not confined to procedures that are used to make financial reporting more reliable. Yet though 90% of companies in the sample described their internal control procedures for financial reporting, just 55% provided information on operational control procedures, while 31% referred to procedures to ensure compliance with laws and regulations.

3.1.6 Resources assigned to internal control

Some 87% of sample companies provided information on the resources devoted to internal control, with 88% of them supplying staffing details (number, functions, reporting lines). By contrast, a mere 7% of companies in the sample supplied a clear organisation chart for this area.

No company indicated the overall cost of internal control, probably because this is difficult to assess and companies do not view the measure as an especially helpful one. However, 23% of companies in the sample referred to investments made to set up or monitor the internal control system. Most often, these expenditures related to introducing standards, strengthening teams and developing systems and procedures.

Pending the release of internal control standards for French companies, the AMF once again recommends that companies describe the resources that they devote to internal control, since this information is valuable to shareholders.

3.2 Due diligence and directors' assessments of procedures

3.2.1 Due diligence performed in connection with the report

In all, 63% of companies in the sample provided details of the due diligence performed in connection with their report, up from 25% last year.

A full 76% of companies said due diligence issues were covered in the context of board discussions, 67% said these matters were dealt with in accounts committee meetings, almost 83% referred to talks with senior management, and under one-quarter made mention of an external party.

This clarification represents a significant improvement on last year and one that may be attributed to the recommendation made by the AMF in its January 2004 guidelines and in last year's report, in which it stressed that it was "important for shareholders to know whether such committees or the board itself were involved in drafting the report and to what extent". Also, since this is the second year for these reports, companies may have introduced more formal processes to draft their reports before submitting them to shareholders.

The AMF's analysis and interviews also sought to determine the role played by chairmen in the drafting process. It was found that the chairmen of 44% of sample companies did take part in preparing the report. Interviews with statutory auditors and companies revealed that information relayed at the senior management level had raised awareness of the importance of internal control and that the quality of reports had consequently improved relative to 2004.

The AMF again recommends that companies describe the due diligence that went into preparing the report.

3.2.2 Chairman's assessment of the adequacy of procedures

Last year, ten or so of the companies in the sample explained that the ultimate objective of current and future work was to achieve an assessment of the adequacy and effectiveness of their procedures, and a handful of these companies had even set a timeframe for meeting these objectives. The AMF called for this added clarification in its recommendations on publishing internal control information and in last year's report.

Specifically, the AMF said it would be helpful if the 2004 reports covered progress made on this type of assessment work, with a review of the action taken in 2004 and a plan of action for 2005.

In 2004, 26% of companies in the sample (of which around one-third are also listed in the USA) said that they had assessed their internal control procedures. Of these, 64% detailed the scope and/or limitations of their assessment and 32% supplied the results. In some cases, companies merely stated that their internal control system had not displayed any significant deficiencies.

Of the companies that did not perform an assessment, 14% gave a timeframe for introducing assessments and described the resources that they intended to deploy to this effect. Only 8% gave a progress report on these efforts.

Accordingly, companies still need some encouragement on this point. Interviews with companies and statutory auditors revealed that companies have adopted a wait-and-see position, because work is still ongoing on industry standards and because they are afraid of being in the first wave to make disclosures in this area. Because they lack a basis for comparison, companies are worried about how they will be positioned with respect to the market if they send out overly negative signals compared with other companies in similar situations.

The AMF was pleased to note that 26% of companies in the sample had adopted a evaluation system for their internal control procedures. International convergence is still a key priority for the AMF, and the creation of standards that reflect their legal environment should help French companies to pursue their evaluation efforts.

The AMF once again recommends that companies report on progress made in their evaluation projects.

3.2.3 Identification of material failures and deficiencies in internal control

As with last year, none of the reports mentioned material failures or deficiencies in internal control.

However, of the companies that performed an assessment and disclosed the results, 14% described reservations or weaknesses in internal control that appeared when the report was being prepared. Just two companies reported immaterial weaknesses last year.

Furthermore, 24% of companies in the sample described measures aimed at achieving improvements. Companies that performed assessments talked about monitoring remedial plans, strengthening and standardising procedures, and extending procedures to include subsidiaries. Companies that did not perform assessments mentioned assigning this task to an external provider and strengthening internal control teams.

The AMF once again recommends that companies tell the market about material failures or deficiencies in internal control, where these have been detected during an assessment or at any time and especially when compiling the chairman's report.

3.3 Statutory auditors' reports

A total 95% of the companies in the sample[43] appended the statutory auditors' report to their report. All the auditors' reports followed the format recommended by the CNCC.

The statutory auditors had reservations or made observations in just 1% of the reports analysed.

None of the reports mentioned any material deficiencies in internal control that would have required the statutory auditors to notify the companies' senior management or board, in accordance with the relevant CNCC standard [44].

None of the statutory auditors' reports mentioned additional due diligence that the auditors had to perform because the company's internal control system was deemed to be inadequate.

It is hard to assess the scope of the auditors' conclusions on the chairmen's reports. If material shortcomings had been detected, statutory auditors would be liable if they allowed this information to be withheld from the market.

[43] This is a requirement only for French limited-liability companies.

[44] CNCC Standard 2-107.

CONCLUSION

In 2005, market disclosures on 2004 corporate governance and internal control by the companies in the sample were of a higher quality overall than the 2004 disclosures made with respect to 2003.

Once again, the AMF found considerable disparities between companies' disclosures in these areas. However, these differences were more pronounced in internal control than in corporate governance, where companies can rely on more familiar, longer-standing industry recommendations.

With the Financial Security Act coming into effect for the first time, last year's reporting exercise was a rather formal one. Meanwhile, this year's reports revealed significant advances in a number of areas. Companies made progress in their disclosures of restrictions on chief executives' powers, the tasks assigned to boards, evaluations of board performance and due diligence performed in connection with internal control reports.

As intimated in the conclusion to last year's report, the AMF has set up a market-wide working group to propose a set of internal control standards suited to the French legal and business environment. As well as providing a valuable framework for companies that decide to follow the AMF's recommendations and assess their internal control procedures, these standards should also promote greater uniformity in internal control reports. The project is slated for completion in first-half 2006.

In conclusion, the AMF wishes to reiterate:

- the importance of disclosures on the resources devoted to internal control procedures and on the due diligence performed in connection with drafting the report;
- the obligation for securities-issuing 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 a material shortcoming or failure in internal control identified in the assessment process or in the due diligence performed in connection with the report.

Description of the sample

The analysis of disclosures by companies making public offers of securities was made as of 30 October 2005 on the basis of the following sample:

- 108 reports.
- All reports by CAC 40 companies (according to the composition of the index at 31 December 2004) were examined.
- 93% of the companies in the sample issue shares that are traded on Eurolist, while the rest issue bonds or shares that are traded on the Marché Libre.
- 93% of companies in the sample have their registered offices in France. Of these, 94% have been incorporated as limited-liability companies and 5% are limited stock partnerships. One European company was included in the sample.
- 36% of the companies in the sample are in the CAC 40 stock index.
- 21% of the sample companies have to comply with the American Sarbanes-Oxley Act.

Companies in the sample

ABC ARBITRAGE
ACCESS 2 NET
ACCOR
ACTEOS
ADL PARTNER
AGF (Assurances Générales de France)
AIR LIQUIDE
ALCATEL
ALGORIEL
ALPHA MOS
ARCELOR
ARES
AREVA
ATOS ORIGIN
AXA
BCI NAVIGATION
BNP PARIBAS
BOLLORE
BOURSE DIRECT
BOURSORAMA
BOUYGUES
CAISSE DE REFINANCEMENT DE L'HABITAT
CAP GEMINI
CARREFOUR
CASINO GUICHARD-PERRACHON
CIC PARIS
CIDER SANTE
COMPAGNIE FINANCIERE DE DEAUVILLE
COURTOIS
CREDIT AGRICOLE
CCF
CREDIT DU NORD (GROUPE)
DALET
DANONE
DASSAULT AVIATION
DEXIA
DOCKS LYONNAIS
DYNACTION
EADS
EIFFAGE
ELECTRICITE ET EAUX DE MADAGASCAR
ENCRES DUBUIT
ESI GROUP
ESSILOR INTERNATIONAL
ESSO SAF
EURODISNEY
EURONEXT NV
EUROTUNNEL
FAURECIA
FINATIS
FINAXA
FONCIERE EURIS
FLOREANE
FRANCE TELECOM
GALERIES LAFAYETTE
GEMPLUS INTERNATIONAL SA
GFI INFORMATIQUE
HAVAS
IB GROUP
IDI
ILOG
INGENICO
INFOVISTA
IXIS CORPORATE & INVESTMENT BANK (ex CDC IXIS CAPITAL MARKETS)
JC DECAUX SA
LAFARGE
LAGARDERE
LEON DE BRUXELLES
L'OREAL
LVMH
MARNIER LAPOSTOLLE
MB ELECTRONIQUE
MICHELIN
MILLIMAGES
PARTICIPEX
PENAUILLE POLYSERVICES
PERNOD RICARD
PEUGEOT
PINAULT PRINTEMPS REDOUTE
PRISMAFLEX
PUBLICIS GROUP SA
QUANTEL
RENAULT
RUBIS
SAINT-GOBAIN
SANOFI -AVENTIS
SCHNEIDER ELECTRIC SA

SCOR
SECHILIENNE SIDEC
SII
SNECMA
SOCIETE GENERALE
SODEXHO ALLIANCE
SOFTCOMPUTING
SOREFICO COIFFURE
SQLI (GROUPE)
STMICROELECTRONICS NV
SUEZ
TEAMLOG
TF1 (TELEVISION FRANCAISE 1)
THALES (ex-THOMSON-CSF)
THOMSON (ex-THOMSON MULTIMEDIA)
TOTAL
VEOLIA ENVIRONNEMENT (ex-VIVENDI ENVIRONNEMENT)
VINCI
VIVENDI UNIVERSAL
WENDEL INVESTISSEMENTS
ZODIAC

APPENDIX II: Excerpt from the AFEP/MEDEF report: definition of an independent director

8. INDEPENDENT DIRECTORS

8.1. *"A director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgment".* Accordingly, an *"independent director"* is to be understood not only as a *"non-executive director"*, i.e., one not performing management duties in the corporation or its group, but also one devoid of any particular bonds of interest (significant shareholder, employee, other) with them.

8.2. Even though the quality of the Board of Directors cannot be defined simply by reference to a percentage of independent directors, as the directors are above all required to be competent, active, in regular attendance and involved, it is important to have on the board of directors the presence of a significant proportion of independent directors not only in order to satisfy an expectation of the market but also in order to improve the quality of proceedings.

The independent directors should account for half the members of the Board in widely-held corporations and without controlling shareholders. In others, the rule of "a third at least" set by the Viénot report of July 1999 should be observed.

8.3. Characterisation as an independent director should be discussed by the appointments committee and reviewed every year by the Board of Directors prior to publication of the annual report.

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[2] These are based on Articles L.225-23 and L.225-27 *et seq.* of the Commercial Code, respectively. In addition, the law limits to a maximum of three the number of directors bound to the corporation by contracts of employment (Article L. 225-22 of the said Code).

It is up to the Board of Directors, upon the motion of the appointments committee, to review individually the position of each of its members on the basis of the criteria mentioned below, then to notify its conclusions to the shareholders in the annual report and to the shareholders' meeting at the time of the particular director's appointment, so that identification of independent directors is carried out not only by the corporation's management but by the Board itself.

The Board of Directors may consider that, although a particular director meets all of the above criteria, he or she cannot be held to be independent owing to the specific circumstances of the person or the company, due to its ownership structure or for any other reason, and the converse also applies.

8.4. The criteria to be reviewed by the committee and the Board in order to have a director qualify as independent and to prevent risks of conflicts of interest between the director and the management, the corporation, or its group, are the following:

- ⇨ Not to be an employee or corporate officer of the corporation, or an employee or director of its parent or a company that it consolidates, and not having been in such a position for the previous five years;
- ⇨ Not to be a corporate officer of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or a corporate officer of the corporation (currently in office or having held such office going back five years) is a director;
- ⇨ Not to be[3] a customer, supplier, investment banker or commercial banker:
  - that is material for the corporation or its group;
  - or for a significant part of whose business the corporation or its group accounts;
- ⇨ Not to be related by close family ties to a corporate officer;
- ⇨ Not to have been an auditor of the corporation within the previous five years;
- ⇨ Not to have been a director of the corporation for more than twelve years[4].

8.5. As regards directors representing major shareholders of the corporation or its parent, these may be considered as being independent provided that they do not take part in control of the corporation. In excess of a 10% holding of stock or votes, the Board, upon a report from the appointments committee, should systematically review the qualification of a director as independent, having regard to the make-up of the corporation's capital and the existence of a potential conflict of interest.