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Report of the Working Group Chaired by Olivier Poupart - Lafarge on Audit Committees

22 July 2010

FOREWORD

The role of audit committees was established by the entry into force of the Order of 8 December 2008, which transposes into French law the Directive of the European Parliament and of the Council of the European Union on statutory audits of annual accounts. The Order requires legal persons and entities issuing securities that are admitted to trading on a regulated market to set up specialised committees to monitor issues relating to financial reporting and auditing. These committees are generally known as “audit committees”.

The establishment of the audit committees’ role is shrouded in uncertainty. Since the publication of the Order, questions have arisen about a new form of responsibility and about clarification of new requirements and changes to the scope of various duties. To address these questions, and in light of the growing importance of corporate governance, the AMF carried out an analysis of the new legislative framework governing audit committees.

The AMF has been actively involved in internal control and governance issues since the inception of the 2003 Financial Security Act. By setting up a working group on audit committees, the AMF has demonstrated that these committees are a core concern and one of the latest major regulatory issues.

The new tasks of audit committees set out in the Order, which include monitoring the effectiveness of internal control and risk management systems, as well as monitoring the financial reporting process, can be seen as more than a question of administrative constraints : they can be seen as factors contributing to profitable and sound companies, and become a enduring source of confidence.

The law sets out the legal framework, but the AMF felt it should take this opportunity to emphasise the audit committees’ key duties, to clarify their scope for action and to propose a practical approach to implementation, thus laying down the fundamental building blocks and avoiding discrepancies in practices. At the same time, the AMF's analysis covered legal notions such as responsibility, giving possible guidance for further developments in addition to dealing with policy issues. It must be stressed that audit committees are offshoots of boards of directors or supervisory boards and their existence does nothing to diminish the responsibility of these boards in the relevant areas. The boards must deliberate these matters, along with the Chairman’s report on internal control and risk management, with the requisite care to ensure that the company complies fully with its obligations.

Furthermore, the discussion provided an opportunity to update the AMF reference framework for internal control systems. Designed and issued in 2007, the framework is primarily a tool for improving corporate management. The update helped to ensure greater uniformity of the concepts underpinning the work of audit committees and the drafting of chairmen’s reports on internal control and risk management.

The AMF would like to extend its heartfelt thanks to all of the working group members for their contribution to this discussion.

The Chairman of the working group

Olivier Poupart-Lafarge
Member of the AMF Board

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INTRODUCTION

The Order of 8 December 2008 transposes the European Directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts into French law. Article 14 of this Order, which has been transposed into Articles L. 823-19 and L. 823-20 of the Commercial Code, institutes specialised committees, known as audit committees, for entities issuing securities admitted to trading on a regulated market. The task of the committees is to monitor matters relating to financial reporting and auditing. The committees act under the "exclusive and collective responsibility" of the members of the administrative body or the supervisory body, as the case may be.

Without prejudice to the powers of the administrative, management or supervisory bodies, audit committees are responsible for monitoring:

- the financial reporting process;
- the effectiveness of the internal control and risk management systems;
- the statutory audit of the annual accounts and, where relevant, the consolidated accounts;
- the independence of the statutory auditors.

Furthermore, the DDAC[1] Act adopted on 3 July 2008 containing various provisions to bring France's company law into line with European law amended Articles L. 225-37 and L. 225-68 of the Commercial Code to expand the scope of the chairman of the board's report on internal control procedures to encompass the risk management procedures implemented by the company.

The AMF set up a working group with thirty members[2] drawn from practitioners and experts in these fields to address these new legal requirements in order to answer questions from many members of the financial community about how the new provisions will affect current practices.

The goal of the working group was to deal with both audit committees per se and the adaptation of the AMF reference framework for internal control. One of the cross-cutting themes in this report is risk management, since it is one of the leading innovations under the new laws.

The working group's methodology was based on:
- analysing the transposition of the "Statutory Audit Directive" in several European countries;
- reviewing the literature on the topic as well as current practices in large corporate groups;
- interviewing persons skilled in this area.

The working group structured its discussions around three main themes:
- analysis of the laws and the main characteristics of audit committees;
- the membership, powers, independence and responsibility of audit committees;
- fulfilling audit committees' duties.

This report is the result of the working group's discussions and it is intended to be of practical use. It specifies the characteristics and duties of audit committees, taking care to define the concept of "monitoring", which is used repeatedly to describe the committees' tasks and accountabilities, and providing practical implementation advice.

The discussion took place in the light of the key obligations incumbent upon audit committees. The working group preferred a pragmatic approach, proposing a specially modified system for midcap and small cap companies[3].

This report is not intended to take the place of specific regulations applying to certain business areas, such as banking and insurance.

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[1] Act containing various provisions to adapt French company law to European legislation, called the "DDAC Act", which amends Articles L. 225-37 and L. 225-68 of the Commercial Code.

[2] See Annex 1 for a list of the group's members.

[3] Companies with a market capitalisation of 1 billion euros or less, as defined by the AMF following the Mansion Report in November 2007. This threshold corresponds to the criteria defined by NYSE Euronext for listings in Euronext compartments B and C.

1. PRELIMINARY ANALYSES

The remit, duties and scope for action of audit committees are set out in a legal framework that establishes the roles and duties of boards of directors, supervisory boards and executive management.

1.1. Review of applicable laws and regulations

The purpose of this review is to show the background to the discussions leading up to the adoption of European provisions that require companies to have audit committees.

1.1.1. Directive 2006/43/EC of 17 May 2006 and other preliminary European legislation

Article 41 of Directive 2006/43/EC of 17 May 2006 on statutory audits of annual accounts and consolidated accounts lays down the principle of requiring certain companies and structures to establish "audit committees". The recitals of the Directive stress that audit committees and effective internal control systems, "help to minimise financial, operational and compliance risks, and enhance the quality of financial reporting [4]."

With regard to the establishment and functioning of audit committees, Recital 24 of the Directive stipulates that: "Member States might have regard to the Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, which sets out how audit committees should be established and function."

Article 6.1 of the Commission Recommendation of 15 February 2005 stipulates that: "The nomination, remuneration and audit committees should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The primary purpose of the committees should be to increase the efficiency of the (supervisory) board by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free of material conflicts of interest."

Annex I to the Recommendation of 15 February 2005 sets out the following rules with regard to the objectives of audit committees:

"1. With respect to the internal policies and procedures adopted by the company, the audit committee should assist the (supervisory) board to at least: (i) monitor the integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting methods used by the company and its group (including the criteria for the consolidation of the accounts of companies in the group), (ii) review at least annually the internal control and risk management systems, with a view to ensuring that the main risks (including those related to compliance with existing legislation and regulations) are properly identified, managed and disclosed, (iii) ensure the effectiveness of the internal audit function (…)

2. With respect to the external auditor engaged by the company, the audit committee should at least: (i) make recommendations to the (supervisory) board in relation to the selection, appointment, reappointment and removal of the external auditor[5] by the body competent under national company law, and to the terms and conditions of his engagement, (ii) monitor the external auditor's independence and objectivity, in particular by reviewing the audit firm's compliance with applicable guidance relating to the rotation of audit partners, the level of fees paid by the company, and other related regulatory requirements, (iii) keep the nature and extent of non-audit services under review, based inter alia on disclosure by the external auditor of all fees paid by the company and its group to the audit firm and network, with a view to preventing any material conflicts of interest from arising (…)".

1.1.2. Order 2008-1278 of 8 December 2008 and Article L. 823-19 of the Commercial Code

Order 2008-1278 of 8 December 2008 transposed the Directive on statutory audits into French law by requiring certain entities to establish "specialised committees". The notion of audit committees from the Directive has been turned into "specialised committees" in the Order. This linguistic precaution stems from the option that the board

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[4] See 24 in the recitals of the Directive.

[5] This provision is not applicable in France.

of directors or supervisory board has to give the specialised committee another name, or to set up other committees, without being limited to setting up an audit committee only[6].

The transposition occurs in Article L. 823-19, which stipulates: "legal persons and entities issuing securities that are admitted to trading on a regulated market, along with credit institutions mentioned in Article L. 511-1 of the Monetary and Financial Code, insurance and reinsurance companies, mutual insurance companies governed by Book II of the Mutual Insurance Code and provident institutions governed by Title III of Book IX of the Social Security Code, shall set up a specialised committee acting under the exclusive and collective responsibility of the members of the administrative body or the supervisory body, as the case may be, to monitor matters relating to financial reporting and auditing.

The membership of the committee shall be determined by the board of directors or the supervisory board, as the case may be. The members of the committee must be non-executive members of the administrative body or the supervisory body. At least one member of the committee shall have special competence in accounting or auditing and shall be independent according to specified criteria disclosed by the administrative body or the supervisory body.

Without prejudice to the attributes of the administrative, executive management or supervisory bodies, the committee is responsible inter alia for monitoring:

a) the financial reporting process;
b) the effectiveness of the internal control and risk management systems;
c) the statutory audit of the annual accounts and, where relevant, the consolidated accounts;
d) the independence of the statutory auditors.

It shall give a recommendation regarding the statutory auditors proposed to the general meeting of shareholders or the body fulfilling an analogous function.
It shall report periodically to the administrative body or the supervisory body on the performance of its duties and give immediate notice of any difficulties encountered."

This Article L. 823-19 of the Commercial Code was the basis for the working group's analysis.

1.1.3. Territorial principle

The Directive sets out the principle of setting up audit committees in all companies issuing securities admitted to trading on a regulated market in the European Economic Area, with national legislation stipulating the procedures for applying this principle. French law (i.e. the Commercial Code) applies solely to companies having their registered office in France, but under the terms of the Directive, the audit committee requirement also applies to issuers having their registered office in Europe, if their securities are admitted to trading on a regulated market.

1.2. Management and governance bodies for internal control and risk management

Before examining the scope and role of audit committees, it is first necessary to identify the terms of reference of the **Board of Directors or the Supervisory Board**[7], on the one hand, and those of **executive management or the Executive Board**[8], on the other hand.

However, the goal here is to identify the areas falling within the remit of audit committees, those are the responsibility of the Board and those that are the responsibility of executive management, specifically with regard to internal control and risk management.

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[6] Article R.225-29 stipulates that: "*the board of directors may decide to set up committees to analyse matters that the board or the chairman of the board submit for analysis and advice. The board shall determine the membership and attributions of the committees, which shall act under the responsibility of the board*. "

[7]**In the rest of this report, the "board" refers to the board of directors or the supervisory board.**

[8] **In the rest of this report, "executive management" refers to the executive board or senior management.**

1.2.1. The role of executive management with regard to internal control and risk management

Executive management is responsible for the quality of internal control and risk management systems, whether acting directly or delegating its tasks. It is also responsible for designing and implementing internal control and risk management systems that are appropriate to the size of the company, its business and its organisational structure. This task includes defining the relevant roles and responsibilities within the company.

Executive management ensures constant monitoring of internal control and risk management systems with the aim of ensuring their integrity and improving them by adapting to changes in the company's organisation and environment. It initiates any remedial measures that become necessary to correct problems identified and to stay within accepted risk limits. It also ensures that these measures are carried out.

Executive management ensures that appropriate information is reported in a timely manner to the board of directors or the supervisory board and to the audit committee.

1.2.2. The role of the board with regard to internal control and risk management

The board's involvement in internal control and risk management varies from one company to the next. However, Article L. 225-100 of the Commercial Code requires the board of directors to give an account of risks in its management report, which must include:

- a description of the main risks and uncertainties facing the company,
- a description of the main risks and uncertainties facing the companies included in the consolidated financial statements,
- information about the company's use of financial instruments. This information must deal with the company's objectives and policies regarding financial risk management. It must also address the company's exposure to price risk, credit risk, liquidity risk and cash flow risk.

In practice, the board is informed of the key characteristics (organisational structure, roles and functions of the main players, procedures, risk reporting and control system monitoring structure) of the internal control and risk management systems chosen and implemented by executive management. More specifically, it obtains a comprehensive overview of financial reporting procedures.

Basically, the board ensures that the major risks incurred by the company are in line with its strategies and its objectives and that these major risks are given due consideration in the management of the company.

Under these circumstances, the board is periodically informed of the operating results of these systems, the main problems detected during the previous period and the plans of action decided by executive management.

More specifically, the board checks with executive management to ensure that the monitoring, internal control and risk management systems are adequate to ensure the reliability of the company's financial reporting and to provide a fair view of the company's and the group's earnings and financial situations.

The board may use its general powers as needed to have any audits or verifications that it deems timely carried out or to take any other action that it deems appropriate in this regard.

2. THE MAIN DUTIES OF AUDIT COMMITTEES

2.1. Analysis of the main legislative provisions

Practical specification of the meaning of certain key terms used in Article L. 823-19 of the Commercial Code is called for, in particular:
- "monitoring", since this term is common to the four duties defined by this Article, and
- "financial reporting", since this term is used with regard to the general remit of audit committees.

- ***“Monitoring”***

The remit of the audit committee forms part of the prerogatives and powers assigned to directors and members of the supervisory board. It does not entail day-to-day monitoring since these duties have to be discharged with limited time and resources.

Therefore, the term “monitoring” should be interpreted as the idea of active surveillance of the areas falling within the remit of the audit committees. Monitoring does not mean continuous action by audit committees, but it should enable them to act whenever it is deemed necessary or timely to do so.

Based on the information they receive, audit committees’ monitoring activities should lead them to notify executive management, and inform the board where appropriate, if they detect alarm signals. Audit committees are not meant to act directly in executive management’s stead if they learn of a problem of the risk of a problem.

This monitoring gives audit committee members the necessary distance and enables them to rely on summarised information to give them a sufficient grasp of the procedures introduced, the key findings of the audits carried out and progress on risk management plans.

Audit committees may also take up any other matter that they deem useful or necessary as part of the performance of their duties and ask executive management for any information.

- ***“Financial reporting”***[9]

Financial reporting covers historical accounting and financial information (periodic reporting), as well as forecasts and other financial information produced by means of a structured compilation process. Forecasts include earnings forecasts published by companies or used for accounting assessments.

2.2. The role of audit committees and their duties

It should be remembered from the outset that the role of an audit committee is not to take the place of executive management.

2.2.1. General duties and scope for action of audit committees

Audit committees play a leading role in accounting and financial matters since they are responsible for monitoring issues relating to compiling and auditing financial reporting. They prepare the board’s decisions to approve the annual financial statements and to examine the half-yearly statements. In this sense, audit committees act as “advisers” to the administrative or supervisory bodies and, more specifically, with regard to the specific powers stipulated by law.

The law explicitly stipulates that audit committees shall monitor:

a) the financial reporting process;
b) the effectiveness of the internal control and risk management systems;
c) the statutory audit of the annual accounts and, where relevant, the consolidated accounts;
d) the independence of the statutory auditors.

Article L. 823-19 of the Commercial Code stipulates that audit committees are responsible ***inter alia*** for monitoring the items mentioned in a) to d), which means that the board can charge the audit committee with any other duties falling within the board’s functions that it deems timely.

[9] This definition of financial reporting applies with regard to the duties of audit committees under the terms of Article L. 823-19 of the Commercial Code.

- ***Audit committees' scope for action with regard to monitoring the effectiveness of internal control and risk management systems***

The working group considered audit committees' scope for action with regard to its duty to monitor the effectiveness of internal control and risk management systems.

As a general rule, internal control and risk[10] management systems are not restricted solely to financial matters and encompasses all aspects of the company. Under the terms of reference, audit committees play a leading role with respect to accounting and finance. This means they are responsible for ensuring that a process exists for identifying and analysing the risks that are likely to have a material impact on financial reporting, and on the company's net worth in particular, and this applies to all risks in all time scales.

It is up to executive management to monitor and manage risks as well. Even though management decisions regarding risks are part of executive management's action, the role of audit committees is to monitor both the identification and analysis of risks, along with changes over time.

This means that audit committees' must examine:

- risks reported in the financial statements (including information in the notes to the financial statements);
- risks identified by internal control and risk management systems set up by executive management that could have an impact on the financial statements.

Audit committees may also be called upon to consider the potential impact on the financial statements of unidentified material risks that they learn about or identify in the performance of their duties.

The board may also opt to monitor other major risks identified by executive management or to charge the audit committee or other board committees with this monitoring.

2.2.2. Analysis of audit committees' main duties

- Monitoring the financial reporting process

The use of the expression "process" implies that audit committees are not required to monitor (in the sense of check and/or verify) the information reported per se, which is a job for executive management. Instead, audit committees are supposed to be informed about the architecture of all of the systems used for financial reporting. The reporting systems, which depend on the overall organisational structure, are, of course, part of this architecture that audit committees are supposed to be familiar with.

The financial reporting process involves accounting and financial information. Therefore, it should not be restricted to the process of compiling accounting data alone.

Financial reporting:

- stems either from an accounting process, in which case, it needs to be consistent with the accounting data produced,
- or else it does not stem from an accounting process, and audit committees need to ensure that the information is produced by a process that is sufficiently structured or organised to allow an assessment of the quality and accuracy of the information (for example, forecasts, objectives, non-standard performance indicators, restructuring plans, etc.)

In addition to monitoring the process per se, audit committees review financial reporting and, more specifically, the financial statements, questioning the reporting of important events or complex transactions (major acquisitions or disposals, restructuring, hedging transactions, the existence of special purpose entities, major provisions, etc.) that have material impact on the company's financial statements. Audit committees use this approach to understand how these complex matters are taken into account in the financial reporting process and, in doing so, they discharge their duties properly. Audit committees are not supposed to question the substance or the strategic

[10] Risk includes operational risk, credit risk, liquidity risk, market risk and legal risk, along with strategic, industrial and environmental risks (see the AMF recommendation on risk factors published on 29 October 2009).

reasoning behind a transaction, or even make a judgment about its appropriateness. These are matters for the board of directors. Audit committees examine the financial reporting process and how these transactions are reported in the financial statements.

If there are problems in the financial reporting process, audit committees ensure that remedial measures are implemented.

- ❖ Monitoring the effectiveness of the internal control and risk management systems

Audit committees monitor the effectiveness of internal control and risk management systems on the basis of information provided to them or that they request.

Internal control and risk management systems need to be based on standards. The AMF reference framework or any other known standards provide the necessary tools for proper implementation of effective systems.

Audit committees ensure that internal control and risk management systems exist, that they are deployed and that any weaknesses identified give rise to remedial action. However, audit committees are not involved in implementing such systems.

Furthermore, audit committees need to be aware of the findings of internal and/or external audits of these systems in order to perform their monitoring of the effectiveness of internal control and risk management systems so that they can make sure that appropriate plans of action are drawn up and carried out when problems are detected.

In terms of monitoring the effectiveness of internal control and risk management systems, the notion of deficiencies is an important one. Audit committees need to ensure that systems are established for detecting and correcting potential deficiencies. Audit committees assess the seriousness of the deficiencies reported to them and notify the board of them, as appropriate. Remedial action is the responsibility of executive management.

- ❖ Monitoring the statutory audit of the annual accounts and, where relevant, the consolidated accounts

It should be remembered from the outset that, for the purposes of Article L. 823-16 of the Commercial Code, the statutory auditors inform the “specialised committee of:

1) their general work programme, as well as the various test audits carried out;
2) changes that they think should be made to the financial statements or other accounting documents, along with any relevant comments about the valuation methods used to compile the financial statements;
3) discrepancies or inaccuracies found;
4) the findings of their observations and rectifications to the earnings of the current period compared the previous period.”

The purpose of this monitoring of the statutory audit of the financial statements is to enable audit committees to be aware of the main areas of risk and uncertainty regarding the annual financial statements and consolidated statements (including half-yearly statements) identified by the statutory auditors, the audit approach used and any problems encountered in the performance of the audit.

Audit committees examine the main elements affecting the audit approach (consolidation structure, acquisitions and disposals, accounting options, new standards applied, major transactions, etc.) and the material risks relating to financial reporting identified by the statutory auditors.

In addition, audit committees have a dialogue with the statutory auditors and examine their findings. Monitoring the findings enables audit committees to improve their assessment of the financial reporting process and focus on the audit issues identified by the statutory auditors.

Audit committees use the information provided to them to ensure compliance with legal and regulatory requirements regarding financial reporting. Given the complexity of accounting standards, audit committees are to be particularly careful about information published as management estimates and judgments, in order to assess whether it is reasonable. Audit committees also pay close attention to the audit issues identified in the performance of the audit, especially those discussed with financial management. Statutory auditors notify audit committees of the nature and seriousness of problems found in the financial statements, in accordance with Article L. 823-16 of the Commercial Code, and of material internal control weaknesses with regard to the financial reporting procedures.

In addition to discussing the audit of the financial statements with the statutory auditors, audit committees also discuss specific legal requirements with the statutory auditors, such as: the alert procedure (except phase 1), special equity transactions, equal treatment of shareholders, review of forecasts, audits of periodic financial statements by statutory auditors, etc.
At the same time, audit committees look at the tasks relating directly to the performance of the statutory auditors' duties that executive management may have requested.

Audit committees also monitor the budget for statutory auditors' fees to ensure that the proposed budgets are adequate for the duties performed and ensure that joint auditing, where appropriate, is effective.

- ❖ Monitoring the independence of the statutory auditors

Statutory auditors and audit committees examine the risks to the auditors' independence together under the terms of Article L. 823-16 of the Commercial Code. Each year auditors send the audit committees:

a) an independence statement;

b) the total amount of fees paid to the network of statutory auditors by the companies controlled by the company, or the company that controls it, for services that are not directly related to the statutory audit.

c) information about services provided that are directly related to the audit.

Audit committees and statutory auditors examine the safeguards that the latter have taken to reduce the potential risk of undermining their independence and to ensure that they comply with the legal and regulatory requirements regarding incompatibilities set out in the auditors' professional code of ethics.

Where there is uncertainty about certain services, audit committees ask statutory auditors for their analysis and interpretation of the laws and regulations, if the latter do not address the various cases explicitly, along with any supporting opinions issued by the Auditing Board. They ensure that the joint auditor is also notified of the services rendered. Where appropriate, audit committees may ask executive management or the statutory auditors to ask the Auditing Board[11] to clarify ambiguous positions.

Audit committees ensure that statutory auditors' firms have a prior authorisation procedure for work directly related to statutory audits and services[12] rendered by the statutory auditors' network.

Audit committees also give recommendations about the statutory auditors put forward for appointment by the shareholders' meeting, using a call for tenders where appropriate.

[11] Article R.821-6 of the Commercial Code
[12] The term "service" is based on Article L.822-11 of the Commercial Code.

3. AUDIT COMMITTEE MEMBERS

3.1. Membership

Under the terms of Article L. 823-19 of the Commercial Code, the task of appointing the members of the audit committee falls to the board.

It enjoys a large degree of freedom in determining the membership of the audit committee. The law does not require a set number of members for an audit committee. However, in keeping with the European Commission's recommendation of 15 February 2005, an audit committee should have at least three members. Exceptionally, audit committees of small cap and midcap companies may have only two members, as long as the board explains its decision.

However, Article L. 823-19 of the Commercial Code places two restrictions on this freedom to determine the membership of audit committees.

First, audit committee members must be board members, since audit committee members must not perform any management functions[13]. This provision is a way of requiring a minimum of independence for all audit committee members (in addition to the specific independence requirement for individual members).

Second, at least one audit committee member should have "special competence in accounting or auditing and be independent" (see more about these notions below).

These two provisions are the only requirements laid down by the law. Nevertheless, the working group is in favour of audit committee members, beside the expert member, having a minimum level of competence in finance and accounting, even if they are not experts. For this purpose, the board should ensure that the other audit committee members can show a minimum level of competence before they are appointed.

The law also requires the board to disclose the special competence and independence criteria used to select at least one audit committee member.

The working group recommends that these criteria should be disclosed in the company's registration document or in the chairman of the board's report on governance and encourages disclosure of the identity of the relevant member or members.

3.2. Competence

It is the board's responsibility to decide on the required competence criteria. Neither Directive 2006/43 nor Article L. 823-19 of the Commercial Code defines the competence in finance and accounting required.

As a general rule, the competence desired should relate to finance or accounting in listed companies, since it is best if the audit committee member selected for his competence can show special competence in these two areas. Attention could also be paid to competence in internal control and risk management, in view of audit committees' duties.

The competence required could be assessed with regard to the audit committee member's professional experience, education and/or his knowledge of the company's business.

Professional experience acquired from positions in executive management, financial management or an audit firm is likely to qualify as special competence in finance and accounting.

[13] The notion of management is meant in the broadest sense, meaning company officers holding executive positions, as well as members of executive management (CEO, CFO, etc.).

3.3. Independence

The board should set independence criteria[14] that are in line with those set out in the AFEP-MEDEF corporate governance code for listed companies, or the MiddleNext corporate governance code for midcaps and small caps, since the independence criteria applied to audit committee members are the same as those applied to directors or members of the supervisory board of the same company.

4. RESPONSIBILITY RULES

Article L. 823-19 of the Commercial Code stipulates, with regard to the civil liability of specialised committee members, that the latter act: "(…) under the exclusive and collective responsibility of the members of the administrative body or the supervisory body (…)".

Nobody could deem that this article means that the board members are collectively liable for the actions of the specialised committee members[15] and that the specialised committee members cannot be held liable for their actions.

Such an interpretation must be ruled out.

First of all, this interpretation is not supported by any of the European legislation that gives rise to this provision: the Directive of 17 May 2006 and the European Commission Recommendation of 15 February 2005 mention responsibility only in the broadest sense of "being in charge of" and not in the narrow legal sense of "liability".

Secondly, and more importantly, this interpretation is contrary to ordinary law on directors' liability, which is governed by Article L. 225-251 of the Commercial Code.

Under ordinary law, directors are either deemed to be individually liable or jointly liable. If joint liability involves a situation where several directors are jointly liable, this still does not constitute "collective" liability, since joint liability requires personal negligence by each of the directors liable, whereas collective liability implies that directors cannot escape their liability in any way, even if they can prove that they did not commit any negligence. As the commercial chamber of the Court of Cassation ruled on 30 March 2010, ordinary law can only find directors civilly liable for negligence that can be attributed to them personally. They cannot be held liable if there is no negligence[16].

This means that a literal interpretation of Article L. 823-19 of the Commercial Code would lead to the astonishing situation where, alongside the principle of directors' liability based on negligence, there would be a set of rules under which the same directors would be liable for the actions of audit committees, even in the absence of negligence[17].

In reality, Article L. 823-19 means that audit committees' actions must come under the responsibility of the board. The term "exclusive" implies the lack of specific responsibility of the audit committee members: they can only be responsible for their actions in their capacity of board members and not in their capacity as specialised committee members.

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[14] See Annex 2.

[15] In any case, board members cannot be held criminally responsible for the acts of the specialised committee members, since French law does not recognise criminal responsibility for the acts of others.

[16] Ruling 08-17.841 of the Court of Cassation handed down on 30 March 2010 does state that negligence is presumed on the part of a director or a member of the executive board. However, the latter may still exonerate themselves of liability by proving that they have performed their duties prudently and diligently, for example, by opposing a negligent decision made by the board, by having their suggestions and reservations noted in the minutes, or even by resigning their directorship.

[17] Article R. 225-29 of the Commercial Code, which allows boards of directors to set up special committees, stipulates that these committees act under the responsibility of the board. It does not say anywhere that this responsibility is "exclusive and collective". The same is true for committees set up by the supervisory board under the terms of Article R. 225-56 of the Commercial Code.

As for the term “collective responsibility”, which has hitherto been unknown in French law, the lawmaker seems to have used this term to indicate that the actions of the specialised committee members are, in principle, those of the directors collectively. Even though the directors are collectively responsible in principle, individual directors can refute their responsibility by proving that they have performed their duties prudently and diligently, for example by opposing a negligent decision made by the board, by having their suggestions and reservations noted in the minutes, or even by resigning their directorship. In this way, the directors’ responsibility for the specialised committee’s actions is that provided for under ordinary law.

This interpretation is in line with French positive law, which does not recognise the concept of collective responsibility and requires that negligence be attributed to an individual director in order for him to be held liable. Furthermore, this leads to a similar solution in principle to those found in the other Member States of the European Union.

However, in order to uphold this interpretation of the notion of responsibility, the AMF has referred the matter to the Central Administration of the Ministry of Justice and suggests that the law be amended.

5. EXEMPTIONS FROM THE OBLIGATION TO HAVE AN AUDIT COMMITTEE

Article L. 823-20 of the Commercial Code, stipulates the principles for exemptions from the obligation to have an audit committee:

> The following are exempted from the obligations stipulated in Article L. 823-19:
>
> 1° Persons or entities that are controlled within the meaning of Article L. 233-16, if the controlling person or entity is itself subject to the provisions of Article L. 823-19;
>
> 2° Collective investment schemes mentioned in Article L. 214-1 of the Monetary and Financial Code;
>
> 3° Credit institutions whose securities are not admitted to trading on a regulated market and which have, in a continuous or repeated manner, issued only debt securities, provided that the total nominal amount of such securities remains below 100 million euros and that they have not published a prospectus;
>
> 4° Persons and entities that have a body that performs the functions of the specialised committee stipulated in Article L. 823-19, provided that this body, which may be the administrative body or the supervisory body, is identified and its membership is disclosed.

The exemptions provided for in 1° and 4° call for the following clarifications.

In exemption 1°, the notion of controlled company, within the meaning of Article L. 233-16, is restricted to companies under de jure or de facto control. Consequently, the exemption cannot be obtained by an issuer that is consolidated under the equity method by another company whose securities are admitted to trading on a regulated market and that has its own audit committee.

For the sake of good governance, the working group recommends, however, that listed controlled companies should have an audit committee in order to protect the interests of their minority shareholders.

Exemption 4° applies to companies of all sizes. However, the working group recommends that this exemption should be limited to companies that meet the criteria for small caps and midcaps[18].

If a company decides to attribute the powers of the audit committee to the board, no special provisions govern the membership of the board in its capacity as the audit committee. In such cases, the law does not require the presence of an independent member with competence, or even that the chairman of the board be a non-executive director.

However, the working group recommends that the body performing the functions of the audit committee should include at least one independent member with special competence in finance and accounting. The working group

[18] Companies listed in the Euronext B and C compartments. These criteria may change as part of the future review of the Prospectus Directive.

also recommends that when the chairman of the board is an executive director, he should refrain from attending meetings where the board acts as the audit committee. However, an executive chairman may be invited to attend part of the meeting. Since there is no chairman at such a meeting, the working group encourages boards meeting as audit committees to be chaired by the person designated as competent and independent.

The board explains its position in the registration document and/or the Chairman's report on governance.

6. FULFILLING AUDIT COMMITTEES' DUTIES.

In this section, the working group addresses the practical implications of audit committees' duties and operations.

The group's objective was to put forward a summary methodological approach that will enable all companies to establish audit committees that fully perform their role.

It was not a matter of reproducing the vast research that has already been done[19], which serves as a useful reference. The point was to present a practical approach that meets the needs of listed companies, by providing them with the tools required for their audit committees to do their work properly.

6.1. Approach

6.1.1. Audit committee operating principles

The law says nothing about audit committee operating procedures, which means that the board has the sole power to lay down such procedures.

The board's rules of procedure[20] set out the statutory duties of the audit committee, along with any specific tasks given to it by the board. The rules of procedure also stipulate the audit committee's organisation principles and procedures, such as the number of meetings, drafting an annual work programme, setting the agenda and setting deadlines for producing documents.

The audit committee's annual work programme is appropriate for the company's size, features and key events, such as restructurings and external growth operations, as well as for the findings of the audit committee's previous work.

6.1.2. Appointing audit committee members and chairmen

Under the terms of Article L. 823-19 of the Commercial Code, the task of appointing the members of the audit committee falls to the board. Even though the law does not explicitly require the board to appoint the chairman, the practice is highly recommended because it helps to organise and structure the committee's work. It also facilitates the committee's representation on the board.

The board may provide for appropriate payment of directors' fees to the audit committee members in view of their workload.

6.1.3. Due diligence of audit committee members

The audit committees' duties fall within the framework of the attributions and powers of directors and members of the supervisory board. Consequently, the audit committee members must, in their capacity as directors, be both prudent and diligent.

Since they must perform their tasks with necessarily limited time and resources, audit committees should have a proper perspective to ensure that their work programmes truly enable them to fulfil their duties.

[19] See Annex 3.

[20] The AFEP-MEDEF and MiddleNext governance codes for listed companies call for these rules of procedure to be drafted.

6.1.4. Audit committees' relations with their companies

Audit committees can meet with anyone in the company that they deem helpful for fulfilling their duties, including members of executive management. Usually, audit committees meet mainly with the persons in charge of the accounting and finance functions.

If companies have the relevant structures, audit committees can also meet with the persons in charge of cash management, internal audit, internal control, management control, risk management and legal affairs, as well as with the persons in charge of the operational divisions, where appropriate.

These meetings help audit committee members fulfil their duties more effectively. The meetings are set up at the audit committee members' initiative. The audit committee defines the terms of the meetings and the expected results. In practice, it is important for audit committees to be able to choose to hold meetings without the presence of the persons in charge of the accounting and finance functions or members of executive management.

- Relations between parent company audit committees and subsidiary audit committees.

Several companies in a listed group may have audit committees, either on a voluntary basis or else because their securities are admitted to trading on a regulated market. No law governs relationships between the different audit committees in a group and there is no guidance on such matters as information sharing between parent company audit committees and subsidiary audit committees.

In the case of fully consolidated subsidiaries, the parent companies' audit committees should be aware of the key findings of the subsidiaries' audit committees with regard to the group's financial reporting or internal control and risk management procedures.

Where appropriate, subsidiaries' audit committees may disclose major problems found by the statutory auditors to parent companies' audit committees through the appropriate corporate bodies.

Similarly, audit committees of subsidiaries consolidated by the equity method could communicate with parent company audit committees through the appropriate corporate bodies, unless the parent company's influence over the subsidiary is too limited in practice to arrange for specific exchanges of information that are consistent with the parent company's reporting schedule.

6.1.5. Audit committee's relations with statutory auditors

Audit committees meet with the statutory auditors each year when the interim and annual financial statements are compiled and as many other times as deemed desirable. These relations are particularly important because the law requires audit committees to monitor the statutory audit of annual financial statements and, as the case may be, consolidated financial statements, as well as monitoring the independence of the statutory auditors.

At least once a year audit committees meet with the statutory auditors without company representatives being present.

6.1.6. Features of the key information that different players provide to audit committees

Audit committees rely mainly on summary information provided by management and information gathered from interviews.

Under this system, audit committees receive the relevant documents and analyses in a timely manner in advance of their meetings. The content and format of these documents must ensure that the information is comparable between periods and provide the audit committee members with the necessary familiarity with the expected information.

The documents deal with matters relating to the various tasks given to audit committees. For example, with regard to financial reporting, the documents provided in addition to the financial statements may be reports on changes in accounting methods, major reporting options, large and unusual transactions, the company's financial situation, monitoring of management estimates and decisions or even disputes and other liabilities (including offbalance sheet items). The documents also include reports on internal control procedures, which should present a summary[21] of the work done by the statutory auditors, and a summary report produced by the internal audit function, if there is one. These documents should cover all matters that are likely to have a material effect on the financial statements and the relevant financial disclosures.

With regard to risk management, executive management transmits the findings of its work on risk identification and analysis and relates it to the published information about risks.

Audit committees are also entitled to access to any other information that they deem relevant for the fulfilment of their duties.

Finally, audit committees may call on external experts when the situation warrants it, after notifying the chairman of the board or the board per se. In this case, audit committees have to report on the experts' findings to the board.

6.1.7. Audit committees' relations with boards

Audit committees must not take the place of boards. They are offshoots of boards and carry our preparatory work for board meetings.

This means that audit committees report on their work to the board periodically and, at the very least, when the annual and high-yearly financial statements are compiled.

Their reports are noted in the minutes of the board meeting. Where appropriate, their reports may be produced as separate documents. In addition to a summary of the audit committee's work, the report may contain the committee's advice and recommendations to the board.

Given the importance of audit committees' tasks, they need to be given enough time at board meetings to present their results and the conclusions of their work.

6.1.8. Assessing audit committees' work

Assessment of audit committees should be discussed each year, when its operations are presented to the full board. The board can then assess the work actually done by audit committees with regard to the objectives set for them and the original work programme. Then the board can suggest areas for improvement in the audit committees operations.

6.1.9. Specific features of audit committees in companies with an executive board and a supervisory board

Unlike the board of directors, the supervisory board "permanently supervises the executive board's management of the company", under the terms of Article L. 225-68 of the Commercial Code. The supervisory board, unlike the board of directors, has a supervisory function only.

Paragraph 5 of Article L. 225-68 further stipulates that "Following the close of each accounting period and within a time limit determined in a Conseil d'Etat decree [three months – see Article R. 225-55 of the Commercial Code], the executive board also presents to it, for verification and inspection purposes, the documents referred to in the second paragraph of Article L225-100 [meaning the annual financial statements and the consolidated financial statements]. Paragraph 6 adds, "the supervisory board presents its observations on the executive board's report and the accounts for the period […]"

Consequently, the supervisory board's supervision is performed after the fact, meaning after the executive board has presented the financial statements. In practice, the executive board draws up the financial statements and presents them to the audit committee, which makes its observations known to the supervisory board.

[21] The summary must include the main adjustments recommended, whether or not executive management has acted on them.

Requiring the audit committee to look at the financial statements could mean that the supervisory board takes more time to verify the financial statements. Consequently, the working group recommends that the audit committees' work should, as far as possible, not involve additional time between the presentation of the financial statements by the executive board and their verification by the supervisory board.

6.1.10. The link between audit committees and the chairman's report on internal control and risk management procedures

Articles L. 225-37 and L. 225-68 of the Commercial Code stipulate that the chairman of the board of directors must describe the company's internal control and risk management procedures in a report, with details about procedures relating to financial reporting for the parent company financial statements and, as the case may be, the consolidated financial statements.

This means that the report deals with all internal control and risk management procedures, going beyond financial reporting alone, even though it specifically details the financial reporting procedures.

The report is produced by the chairman of the board and must also be approved by the board.

In view of the audit committees' statutory duties with regard to monitoring the effectiveness of internal control and risk management systems, it would be helpful if the board stipulates that the audit committee read the chairman's report and, where appropriate, make observations with regard to matters falling within its remit.

6.2. The role of audit committees in financial disclosures and reporting

It is the responsibility of executive management to implement the company's financial disclosure policy, and to develop and verify the various media used for this disclosure.

Audit committees' role in financial disclosure depends largely on the board and its decisions on the committee's role in this matter.

Before specifying this role, an analysis of what a company's financial disclosure entails needs to be carried out. In addition to statutory and regulatory disclosures, issuers can opt to disseminate further information using different media. In practice, financial disclosure varies according to the type of information (press releases, slides, annual reports, etc.) and the intended audience (shareholders, creditors, analysts, etc.)

Financial disclosure takes the form of press releases when periodic disclosures are published (annual and half-yearly financial statements, quarterly disclosures). Press releases should contain all of the material information. In addition to press releases, more detailed documents for presentations to analysts and investors may be produced, with the stipulation that these presentations must not contain any material information that has not already been disclosed to the market. In addition to these publications, issuers may publish a registration document.

Where appropriate, financial disclosure also covers "sensitive" information, such as profits warnings and announcements of major acquisitions or restructuring plans.

In addition to the financial statements, a great deal of information about risk is disseminated in various financial disclosure documents (registration documents, management reports, internal control reports, etc.)

Periodic financial statements and information about risks are key elements of financial disclosure, which means that these various documents should present consistent information about these matters.

- *Audit committees' role in press releases relating to periodic disclosures*

As part of their duty to monitor the financial reporting process, audit committees ensure that a process is in place to prepare press releases announcing the publication of annual and half-yearly financial statements[22] and quarterly disclosures[23].

If executive management is able to provide a draft of the press release to the audit committee, the board may, before examining the press release itself, ask the audit committee to check the consistency of the presentation of financial disclosures to the market with the financial statements.

Otherwise, the board will carry out this verification directly for the annual or half-yearly financial statements. The same procedure applies if the board holds meeting to examine the press releases for quarterly disclosures.

- *Chairman's report on internal control procedures, management report*

The chairman provides these reports to the board. The board may ask the audit committee for its opinion concerning the content of these reports.

- *Other documents (forecasts, trends, profits warnings and other sensitive information, presentations to analysts and registration documents)*

Executive management prepares and verifies such documents, if they are produced. The board may ask to see these documents and may refer them to the audit committee.

6.3. Reporting significant deficiencies

Statutory auditors must notify audit committees of internal control significant deficiency with regard to the financial reporting procedures, in accordance with Article L. 823-16 of the Commercial Code.

The AMF corporate governance report also points out that issuers must disclose to the market serious internal control failures or weaknesses revealed by an assessment or at any other time, such as during the drafting of the chairman's report.

The working group stresses the need to harmonise the vocabulary used in the AMF report with the notion of "significant deficiency".

If the statutory auditors notify the audit committee of internal control significant deficiency, the audit committee notifies the board and makes sure that the chairman's report on internal control and risk management procedures mentions these deficiencies, if they constitute a significant deficiency.

Drawing inspiration from existing definitions, the working group deems that:

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[22] Parent company and consolidated financial statements.

[23] For the purposes of Article L. 451-1-2 of the Monetary and Financial Code, these financial disclosures include:

1° an explanation of major transactions and events that took place during the accounting period and an explanation of their effect on the financial situation of the issuer and the entities under its control;

2° a general description of the financial situation and earnings of the issuer and the entities under its control during the accounting period;

3° the net revenue by line of business in the most recent quarter and, where appropriate, each of the previous quarters in the financial year, along with the corresponding revenue figures for the previous financial year. These figures are presented for the parent company and, where appropriate, for the consolidated companies.

Readers are reminded that the quarterly disclosures are not necessarily financial statements in the strictest sense and that the figures have not been reviewed by the statutory auditors.

- **a significant deficiency**[24] is a deficiency or a set of deficiencies relating to internal control with regard to financial reporting. It is serious enough to concern the persons responsible[25] for oversight of financial reporting, but not serious enough to be qualified as a material weakness.

- **a material weakness** is a deficiency or a set of deficiencies relating to internal control with regard to financial reporting that is such that it could result in a material misstatement in financial reporting, which, if known to the market, would be likely to have a material impact on the prices of the financial instruments issued by the company.

It is up to the board to assess whether the weakness identified constitutes a material weakness or a major weakness.

The statutory auditors make[26] observations on the chairman's report on internal control procedures if the report omits major internal control weaknesses relating to financial reporting.

7. Special provisions for small cap and midcap companies

This section deals with the special provisions for audit committees in small cap and midcap companies[27]. Such companies have two options: they can either set up an audit committee or obtain the exemption provided for in 4° of Article 823-20 of the Commercial Code.

The law allows for exemptions if persons and entities have a body that performs the functions of the specialised committee stipulated in Article L. 823-19, provided that this body, which may be the administrative body or the supervisory body, is identified and its membership is disclosed.

This means that the duties of audit committees set out in Article L. 823-19 of the Commercial Code must be performed, regardless of whether the issuers chooses to set up an audit committee or to have its board act as an audit committee.

7.1 The audit committee option

If a small cap or midcap company wishes to set up an audit committee, it should comply with the principles set out above with regard to the provisions to be implemented. These provisions deal with audit committees' duties, scope for action, membership and practical implementation.

7.2 The board option

A small cap or midcap company can obtain an exemption from setting up an audit committee if it complies with the conditions set out in Article L. 823-20 of the Commercial Code.
In this case, the board, meeting as an audit committee, must perform the duties of the audit committee.

These duties are set out in Paragraph 2.2 above. At the same time, the definitions of the notions of "monitoring" and "financial reporting" are presented in Paragraph 2.1. These definitions are equally valid for a company obtaining an exemption.

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[24] Subject to the definitions that may be included in the professional practices standards for auditors regarding disclosure of internal control weaknesses.
[25] These persons are the members of the audit committee and the board, as well as executive management.
[26] See the professional practices standards for auditors regarding the auditor's report produced for the purposes of Article L. 225.235 of the Commercial Code.
[27] Companies listed in Euronext compartments B and C. These criteria are subject to changes during the upcoming review of the Prospectus Directive.

Practical implementation calls for clarification of certain points that are not dealt with explicitly by the laws and regulations. These points are:

- Report on the work of the board meeting as an audit committee

Periodic reports are made to the board on the audit committee's work and, at the very least, when the annual and high-yearly financial statements are compiled.

When the board meets as an audit committee, the working group recommends that the board report on the part of the meeting spent on audit committee duties in a special section of the minutes or in separate minutes in order to relate the work done fulfilling the duties of the audit committee.

- Relations between statutory auditors and the board meeting as an audit committee

Under the terms of Article L. 823-16 of the Commercial Code, statutory auditors are required to notify audit committees of certain items (*general work programme, changes that need to be made to the financial statements, discrepancies and inaccuracies discovered, conclusions of observations and proposed rectifications of earnings*), as well as material internal control weaknesses.

If there is no audit committee, the working group recommends that the board be notified directly.

- Chairmanship of the board meeting as an audit committee

There are no special provisions regarding the chairmanship if a company decides to attribute the powers of the audit committee to its board.

The working group also recommends that when the chairman of the board is an executive director, he should refrain from attending when the board meets as the audit committee. However, an executive chairman may be invited to attend part of the meeting. Since there is no chairman for this meeting, the working group encourages boards meeting as audit committees to choose the person designated as competent and independent to chair the meeting.

The board explains its position in the registration document and/or the Chairman's report on governance.

- Presence of a independent member with competence in finance and accounting

If a company decides to attribute the powers of the audit committee to the board, no special provisions govern the membership of the board in its capacity as the audit committee. More specifically, the law does not require the presence of an independent and competent member in such cases.

However, the working group recommends that the body performing the functions of the audit committee should include at least one independent member with at least some special competence in finance and accounting.

The board explains its position in the registration document and/or the Chairman's report on governance.

- Financial disclosure

See Paragraph 6.2 above for information about financial disclosure.

Annex 1

Members of the working group

Chairman: Olivier Poupart-Lafarge, member of the AMF Board

Chairmen of the sub-groups

- Patrice Marteau, Chairman, ACTEO
- Didier Martin, Attorney, BREDIN PRAT
- Gérard Lancner, Chairman, AMRAE

Members of the working group

- Pascale Besse, Chief Financial Officer, SOLUCOM
- Marylène Boyer, Chief Financial Officer, THERMADOR GROUPE
- Annie Bressac, ESCP Europe, Internal Audit Director, Fondation d'Auteuil
- Aldo Cardoso, Chairman of the Audit Committees, IMERYS, RHODIA and GDF-SUEZ
- Philippe Christelle, Internal Audit Director, CAP GEMINI
- Jean-Philippe Desmartin, Analyst, ODDO
- Sylvia Fonseca, Director, Risks and Internal Control, EIFFAGE
- Sylvain de Forges, Risks and Markets Director, VEOLIA Environnement
- Jean-Baptiste Duchateau, Legal Affairs, Company Law and Stock Market Law Director, VEOLIA Environnement
- Jacques Fournier, Representative of the Financial Markets Department, National Auditing Board (CNCC)
- Laurent Guillot, Chief Financial Officer, SAINT-GOBAIN
- Philippe Jeunet, Member of the Executive Committee in charge of Audit and Risk Management, GDF-SUEZ
- Dominique Laboureix, Director of Research and International Relations, SGACP
- Bénédicte Huot de Luze, Scientific Director, AMRAE
- Loïc Le Berre, Deputy Chief Financial Officer, GROUPE GORGE
- Michel Léger, Chairman, BDO
- Xavier Maitrier, Partner in Charge of the "Improving Performance, Risk Management and Internal Control" Department, PWC
- Viviane Neiter, Chairman of the Audit Committee, Dolphin Integration
- Charles Paris de Bollardière, Chairman of the Audit Committee, STERIA
- Jean-Philippe Riehl, Risk Management Director, VEOLIA Environnement
- Jean-Florent Rérolle, Representative, IFA
- Philippe Santi, Deputy Chief Executive Officer, INTER PARFUMS
- Patrick Sayer, Chairman, EURAZEO
- Louis Vaurs, Chief Executive Officer, IFACI
- Caroline Weber, Chief Operating Officer, MIDDLENEXT

- Daniel Barlow, Representative, Central Administration of the Ministry of Justice (DACS)
- Christian Belhôte, Representative, Central Administration of the Ministry of Justice (DACS)
- Emmanuel Susset, Representative, Directorate General of the Treasury and Economic Policy (DGTPE)
- Edouard Vieillefond, Deputy Secretary General, Regulation Policy and International Affairs Division, AMF
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- Etienne Cunin, Accounting Division, AMF
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- Patrice Aguesse, Regulation Policy and International Affairs Division, AMF
- Antoine Colas, Regulation Policy and International Affairs Division, AMF
- Patricia Choquet, Legal Division, AMF
- François Gilbert, Legal Division, AMF

Annex 2

Independence criteria
From the AFEP-MEDEF and MIDDLENEXT Corporate Governance Codes

MiddleNext – Corporate Governance Code for Small Caps and Midcaps – December 2009

R8: Board members – presence of independent members on the board

Background: *Large shareholdings may lead the board to over-represent these shareholders' interests to the detriment of minority shareholders and distort strategic vision or representations of the environment. Therefore, boards should be opened up to outside members who contribute a different viewpoint regarding the board's decisions. However, companies are not always big enough to require large boards and they may have difficulty attracting outside members. Therefore, expectations regarding the number of independent directors should remain realistic.*

Recommendation

The board should include at least two independent members. This number could be one if the board has fewer than six members. It could be higher for large boards.

Five criteria can used to judge the independence of board members, which is characterised by a lack of material financial, contractual or family connections that could affect the independence of the board member's judgment:

- not having been an employee or an officer of the company or of a company in its group within the last three years;
- not being a customer, supplier or banker for the company or its group or for whom the company or the group accounted for a significant share of business;
- not being a major shareholder in the company;
- not having a close family tie to a corporate officer or a major shareholder;
- not having been an auditor of the company within the last three years.

It is up to the board of directors to examine each of its members individually using the criteria above. If it can substantiate its position, the board may deem that one of its members is independent even if he does not meet all of these criteria; it may also decide that one of its members is not independent, even though he does meet all of the criteria.

AFEP-MEDEF – Corporate Governance Code for Listed Companies – December 2008

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 as 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 controlled companies, independent directors should account at least for a third.

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.

The Board of Directors must, upon the motion of the appointments committee, review individually the position of each of its members on the basis of the criteria mentioned below, then 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. Conversely, the Board may consider that a director who does not meet the above criteria is nevertheless an independent director.

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 executive director 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 an executive director of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or an executive director of the corporation (currently in office or having held such office going back five years) is a director;

- Not to be[28] 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 an executive director.
- 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[29].

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 an independent director, having regard to the make-up of the corporation's capital and the existence of a potential conflict of interest.

[28] Or be bound directly or indirectly to.

[29] As a practical guideline, loss of the status of independent director on the basis of this criterion should occur only upon expiry of the term of office during which the 12-year limit is reached.

Annex 3
List of publications on audit committees

- IFACI publications on internal control:

- L'auto-évaluation du contrôle interne, oct.05 (cahier de la recherche-guide d'audit-) ;
- Des clés pour la mise en œuvre du CI, avril 08 (cahier de la recherche- meilleures pratiques-) ;
- Contrôle interne et qualité, pour un management intégré de la performance, mai 08 (cahier de la recherche-notes professionnelles-) ;
- Commentaires relatifs à la transposition des 4ème,7ème et 8ème directives européennes (Groupe professionnel « contrôle interne de l'IFACI), juin 09 ;
- Le contrôle interne du système d'information des organisations, février 09 (Guide opérationnel d'application du cadre de référence AMF relatif au contrôle interne, élaboré par un groupe de travail mixte IFACI/CIGREF).

- IFACI publications on audit committees:

- Audit Committees, good practices for meeting market expectations (produced by PwC and sponsored by IIA, translated into French by IFACI and PwC, May 2002) ;
- Le rôle de l'audit interne dans le gouvernement d'entreprise (prise de position IFA/IFACI, mai 2009).

- IFACI publications on risk management procedures:

- La cartographie des risques, groupe professionnel Assurances, juillet 06 (cahier de la recherche –guide d'audit-) ;
- Etude du processus de management et de cartographie des risques, janvier 2004 (cahier de la recherche –guide d'audit-) ;
- Risk Management, 2001 (translation of an English publication)

- IFA publications:

- La gouvernance des sociétés cotées – synthèse sur les recommandations sur le rôle et les modes d'action des conseils (Mai 2007)
- Les comités d'audit : 100 bonnes pratiques (Janvier 2008)
- Vade-mecum de l'administrateur (Seconde édition, Octobre 2008)
- Prise de position IFA-IFACI sur le rôle de l'audit interne dans le gouvernement d'entreprise (Mai 2009)
- Le rôle de l'administrateur dans la maîtrise des risques (en collaboration avec l'AMRAE, Juin 2009)
- Instauration des comités visés à l'article L823-19 du code de commerce (Note de synthèse de la commission juridique de l'IFA, Octobre 2009)
- Comités d'audit et auditeurs externes (Novembre 2009)

- Cercle des juristes:

- Rapport d'un groupe de travail sur le conseil d'administration et le « comité spécialisé »

- European Issuers:

- Position paper, *"Towards Common Principles for Internal Control & Risk Management Systems at Listed Companies in Europe",* January 2010

- AMRAE documents on audit committees:

- Rôle de l'administrateur dans la maîtrise des risques en collaboration avec l'IFA

AFEP, ANSA, MEDEF and MiddleNext publications:

- Code de gouvernement d'entreprise des sociétés cotées AFEP-MEDEF (Décembre 2008) ;
- Code de gouvernement d'entreprise pour les valeurs moyennes et petites - MiddleNext (décembre 2009) ;
- Systèmes de contrôle interne et de gestion des risques (« CIGR ») Principes communs pour les sociétés européennes AFEP ANSA MEDEF MiddleNext (Mars 2010)