

## **Statement of the European Corporate Governance Forum on Risk Management and Internal Control**

1. During 2005 and since, the Forum has taken account of current developments in requirements for risk management and internal control. Many of these are of comparatively recent origin and experience of their costs and benefits continues to evolve. The Forum considers that recent initiatives in the EU will serve to enhance disclosure and transparency and will also require company boards to keep under regular review issues of risk management and internal control.
2. As the recitals to the new Directive on Statutory Audit<sup>1</sup> state: “... *effective internal control systems contribute to minimise financial, operational and compliance risks and enhance the quality of financial reporting*”. Accordingly, the Directive requires the audit committee (or alternative body) of listed and other eligible public interest entities to monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems.
3. The new amending Directive concerning annual and consolidated accounts<sup>2</sup> requires listed companies to publish an annual corporate governance statement, including a description of the main features of any existing risk management systems and internal controls in relation to the financial reporting process.
4. The Forum is also aware of recent initiatives in many Member States which require or encourage listed companies to exercise risk management and internal control and to report to shareholders by appropriate disclosure. These initiatives embrace a variety of approaches to the scope of the requirements and associated disclosure obligations. It should be noted that

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<sup>1</sup> Directive 2006/43/EC of the European Parliament and the Council of 17 May 2006 on statutory audit of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L157 of 9.6.2006, p. 87

<sup>2</sup> Directive of the European Parliament and the Council of the European Union amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts (not yet published in the Official Journal)

the wider the types of risk to be addressed and the more extensive the disclosures required, the greater the costs, difficulties and challenges faced by management and those charged with governance.

5. There have also been developments elsewhere, notably in the United States where the requirements emanating from Section 404 of the Sarbanes-Oxley Act of 2002 impose important obligations on company directors and management and on auditors. These obligations include published conclusions concerning the effectiveness of internal controls over financial reporting and disclosures of any material weaknesses identified. The Securities & Exchange Commission and the Public Company Accounting Oversight Board have issued rules, standards and guidance implementing the requirements of the Act and have consulted on evolving experience of their implementation. While important benefits, such as greater confidence in financial reporting, have been clearly acknowledged, serious concerns have also been expressed about the costs arising and questions raised about the implementation guidance provided to management as compared to that for auditors. The SEC and PCAOB therefore continue to consider how to retain the benefits while responding to the concerns expressed.
  
6. The Forum recognises that the general purpose of risk management and internal control is to manage the risks associated with the successful conduct of business, not to eliminate them and, more specifically, to enhance the quality of financial reporting. Measures to further these aims, whether in law, regulation or corporate governance codes, should therefore be proportionate and reflect the principles of Better Regulation adopted by the Commission<sup>3</sup>. Specifically, the Forum considers that there should be an adequate balance between the benefits of any additional requirements and the costs and other burdens for companies. Therefore, the Forum while confirming that companies' boards are responsible for monitoring the effectiveness of internal control systems considers that there is no need to introduce a legal obligation for boards to certify the effectiveness of internal controls at EU level.

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<sup>3</sup> Communication of the Commission of 25 October 2005 to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: "Implementing the Community Lisbon programme: A strategy for the simplification of the regulatory environment (COM(2005)535 final; [http://ec.europa.eu/enterprise/regulation/better\\_regulation/simplification.htm](http://ec.europa.eu/enterprise/regulation/better_regulation/simplification.htm))

7. The Forum urges Member States to take account of these points when implementing in national law the associated requirements of the new Directives already mentioned.
  
8. As many of the initiatives on risk management and internal control are recent, a careful examination of the lessons to be drawn from experience should be carried out before considering any further legislative or other measure at EU level. As experience is gained of the various approaches to risk management and internal control at Member State level and in the United States and elsewhere, relevant principles and best practices should be identified, namely those which best fulfil the aims above in a proportionate manner. In due course, such principles and best practices may facilitate convergence within the European Union of requirements in relation to risk management and internal control and evolution of good market practice. Such principles and best practices should be accepted as the basis for any future discussions on equivalence of risk management and internal control measures between the European Union and other competent authorities.
  
9. While there appears to be no current need for further measures, the Forum intends to keep under review whether existing arrangements prove sufficient to ensure that internal controls within the EU meet best practice.

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