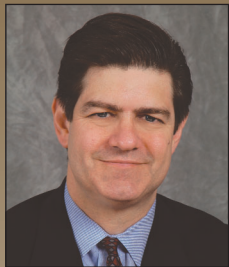


# Get Ready for the EU's 8th Directive

**N**ext year 25 EU member countries are expected to adopt a far-reaching regulatory step toward governance on a global scale — with a direct impact on global U.S. company boards.

By James S. Turley

The 8th Directive on Company Law is to European business what Sarbanes-Oxley is to US SEC registrants: a complex and comprehensive set of legislative reforms that reaches into the very heart of the boardroom. In covering some of the same territory as Sarbanes-Oxley, it represents a welcome step toward the convergence of corporate oversight on a global scale. Like Sarbanes-Oxley, at the core of the



**James S. Turley**  
Chairman & CEO  
Ernst & Young

*“The Directive proposes fundamental changes around a board’s relationship with the auditor.”*

8th Directive is a commitment to the restoration of investor confidence in the markets — which means that directors of US-listed companies with a dual European listing will want to be as familiar with the 8th Directive as they are with Sarbanes-Oxley.

Directors and auditors have a particular responsibility to represent and protect investor interests through the quality, depth and breadth of our respective oversight activities. We all understand that investors have been clamoring for stronger oversight — from directors, auditors, regulators and legislators. This then must be the central question both directors and auditors consider in assessing their response to the 8th Directive and Sarbanes-Oxley.

From our perspective, investor interests will best be protected when this discussion is more globally based, rather than simply focused on Europe or the US, as large and important as those markets are. We live in a world where scores of individual corporations boast revenue figures that exceed the GDP of whole nations. Not only do these global businesses need to be able to operate across borders with consistency of practice, their investors require certainty that their interests will be safeguarded regardless of where business activity occurs — and that means the US, the EU and beyond.

Through their combined and broad reach there is no question that the 8th Directive and Sarbanes-Oxley lay the framework for stronger, more globally consistent corporate governance and clarify and strengthen the role of both director and auditor. The EU is separately looking at a corporate governance directive, and there are also a number of related regulatory and governance initiatives in other countries that are making an important contribution here. In conjunction with the ongoing convergence of international accounting and auditing standards, these initiatives provide investors with confidence that regulators

are very serious about protecting their interests and restoring confidence in the markets.

We would recommend that US directors work quickly to come to an understanding of the 8th Directive and to start early in challenging and implementing changes and improvements. Directors must also lead the charge in championing the convergence of regulatory arrangements so that corporate governance is enhanced around the world in a consistent and high-quality manner.

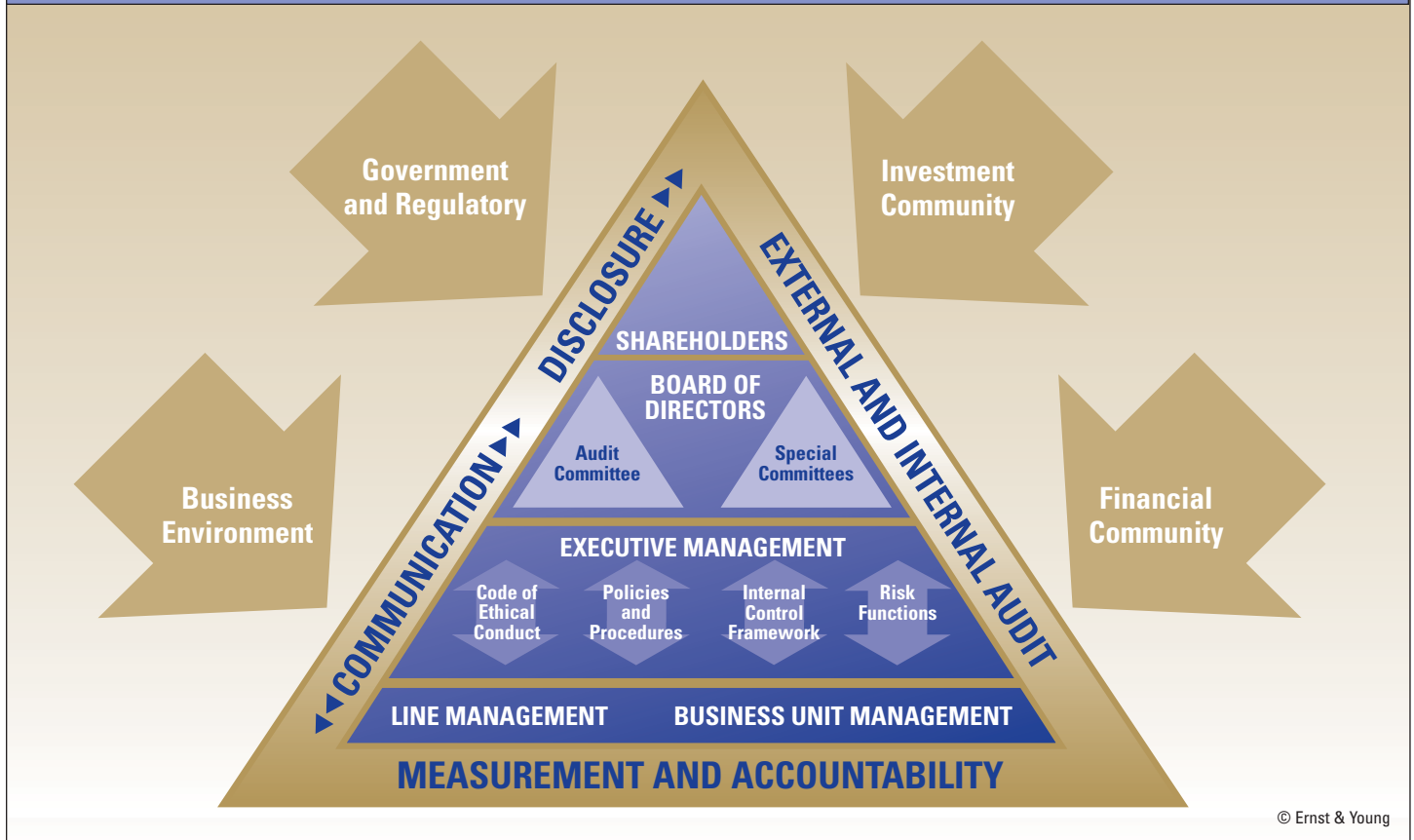
The significance of the 8th Directive lies in the fact that its measures affect all 25 EU member countries and have an extraterritorial impact beside. The Directive establishes a core set of uniform principles for the 25 EU countries. While it provides a strong basis for the harmonization of company audits across Europe, it is important for directors to appreciate that there is some capacity for variation at the individual country level. The EU is expected to adopt the Directive by March 2005, with the 25 member countries required to begin implementing it by January 1, 2006. Like Sarbanes-Oxley, the 8th Directive is a complex package. For directors, we see it as having an impact across two broad areas:

**Responsibilities of the audit committee:** Public interest entities are required to appoint an audit committee, which will have greater responsibility for risk management than before, including oversight of the internal audit function and internal controls structure.

**Directors’ relationship with the auditor:** The audit committee now has responsibility for the selection of the external audit firm and oversight of auditor independence.

**Responsibilities of the audit committee** Let’s take the issues in order. The 8th Directive mandates audit committees for public interest entities, which we believe is absolutely critical to robust boardroom practice. These audit committees are required to have at least one person with financial competency and to be responsible for the appointment of the auditor. The European proposals are an important step in enhancing governance and are being adopted by some boards in advance of the regulatory reform. They will enhance auditor independence by providing a forum for discussion with non-executive directors who are independent of company management. We believe some aspects of corporate governance

## Audit Committees in the New Environment



need to be legislated for, just as some aspects of the audit function should be regulated.

Provisions within the 8th Directive will result in the audit committee taking a greater degree of fiduciary responsibility for risk management. The audit committee is required to monitor the effectiveness of the company's internal controls, internal audit and risk management systems. The auditor is required to report to the audit committee on key matters arising from the statutory audit, including material weaknesses in internal controls in relation to the financial reporting process.

Sarbanes-Oxley also focuses on internal controls, and this is having a major impact on US-listed companies. The US-based group Financial Executives International has estimated US companies with revenues of \$1 billion – \$4 billion may spend as much as \$1.8 million on internal controls in the first year in response to the Section 404 provisions of Sarbanes-Oxley; for companies whose revenues exceed \$5 billion, the first-year cost averages \$4.7 million. Separate Ernst & Young research on the impact of Section 404 on some 100 major busi-

nesses across virtually all industry sectors found 70 percent were devoting more than 10,000 hours to compliance; of the companies with more than \$100 billion in sales, 40 percent planned to incur more than 100,000 hours. Most companies had not included remediation time in their budgets because they were uncertain how to estimate it.

Nevertheless, and without diminishing the importance of these cost issues, the biggest impact of these measures for directors in the EU context is the increasing extent to which boards will be held accountable for risk management.

### Directors' relationship with the auditor

The 8th Directive proposes more fundamental changes around a board's relationship with the auditor. For our part, we particularly welcome the inclusion of measures to coordinate public oversight of the accounting profession across the 25 EU countries. As in the US, it is our view that self-regulation of the profession is no longer appropriate. The PCAOB has been swift and increasingly thorough in its regulation and review of the firms in the US market, and we see this as a positive model to explore elsewhere.

In the same vein, we support the adoption of harmonized ethical standards and quality assurance principles across the EU. Speaking for Ernst & Young, we have clearly acknowledged the need for our profession to respond to recent corporate failures decisively and forcefully, as a means of contributing to the restoration of investor confidence. We have developed a code of conduct to guide behavior around the world; elevated the role of quality and risk management to the Global Board; substantially increased technical and fraud training for our people and added significant technical resources to work with our client-facing teams. We have also tightened client acceptance and continuance criteria; we are actively managing the rotation of our audit partners and teams and in some instances, in response to the marketplace, we are limiting the scope of services we provide beyond levels required by the regulators.

The new role of the independent audit committee in choosing the external auditor is also very positive and should send a clear signal to investors about the key role of the audit committee

*continued on page 20*

*“70 percent of major companies are devoting more than 10,000 hours to Section 404 compliance. 40 percent of firms with \$100 billion in revenue will incur over 100,000 hours.”*

in working with the auditor and the broader board to protect and represent investor interests.

Other issues which will impact the relationship with the auditor include: the option for EU member countries to require audit firm rotation after seven years (against audit partner rotation under Sarbanes-Oxley) and some lack of clarity over those services, which the external auditor is prohibited from providing to the audit client.

In our view, the combined impact of these measures may serve to reduce

director choice as to audit firm appointments. Audit firm rotation would prohibit the appointment of at least the retiring firm (or firms in the case of joint audits); equally, further prohibitions on the non-audit services that can be provided by the auditor would ensure that at least the audit firm providing those services is ineligible for the audit.

Audit firm rotation, as distinct from audit partner rotation, is a particularly difficult issue. Academic studies support the view that audit firm rotation undermines audit quality. In the US, statistical

evidence suggests that three times as many audit failures occur in the first two years of an audit relationship as at any time in the third and subsequent years.

In terms of investor confidence, the voluntary resignation of an auditor presently sends a red flag warning to investors and the capital markets. Compulsory rotation removes the threat — and impact — of voluntary rotation. Conversely, audit partner rotation, as in the Sarbanes-Oxley environment, provides for continuity in the analysis of accounts, combined with the benefits of a fresh leadership team from the audit firm.

Directors may want further clarity on the implications of the 8th Directive's independence principles relating to auditors providing certain non-audit services to the audit client. The Directive raises the possibility of additional restrictions and potentially “total prohibition” on the auditor provision of non-audit services to publicly listed audit clients. This exceeds the EU's current independence provisions and may serve to undermine

### The 8th Directive Meets Sarbanes-Oxley: A Comparative Snapshot

Issue	8th Directive	Sarbanes-Oxley
<b>Audit Committee</b>	Mandatory for listed companies. Must be independent and have at least one financial expert. Appoints or dismisses the auditor	Also requires procedures for complaints from whistleblowers and others
<b>Internal Controls</b>	Requires audit firm report on key matters arising from the audit, particularly material weaknesses in internal controls related to financial reporting	Requirements are more detailed
<b>Public Oversight of Auditors</b>	25 EU member/accession states to appoint oversight boards for auditors, register firms and establish investigative/disciplinary systems	Public Company Accounting Oversight Board (PCAOB) oversees audit of public companies; establishes standards for auditing, registration, quality control, ethics and independence of audit firms
<b>Auditor Independence</b>	Raises the possibility of “total prohibition” on non-audit services	Proscribes specific services and requires audit committee pre-approval for other non-audit services
<b>Firm v. Partner Rotation</b>	Provides for either audit firm or key audit partner rotation, audit firm at seven years and audit partner at five years	Requires lead and concurring audit partner rotation every five years; no requirement for firm rotation
<b>Group Auditor Responsibility</b>	Group auditors bears full responsibility for the audit of the consolidated accounts; responsibility extends to the work of other audit firms	None

Source: Ernst & Young

the role of the independent audit committee by removing any discretion in this area.

Audit-related and other appropriate services can provide auditors with additional understanding of the company and therefore contribute to the quality of the audit. While there is no question that certain services should be proscribed, as outlined in Sarbanes-Oxley, we also see that the multidisciplinary model strikes an appropriate balance: It allows the audit firm to enhance its knowledge of the business while giving the independent audit committee the capacity to make appropriate decisions about the source and quality of its professional advice.

#### The case for global convergence

While the 8th Directive has yet to be passed into law, it represents a significant step in the right direction as far as investor protection and strong corporate governance are concerned. We are not alone in saying that the global capital markets require globally consistent regulatory and standards regimes. The

close alignment of the 8th Directive and Sarbanes-Oxley is a powerful contributor to this agenda, and we hope other jurisdictions will approach their governance regimes with the same spirit of reciprocity and common sense. As noted earlier, we would encourage directors to lead the charge in championing such convergence.

But it is important to remember that such initiatives are only part of the story of appropriate governance on a global scale. Commentators, shareholders and regulators are also concerned about the "tone at the top," and this issue is squarely in the hands of directors. And here recent actions by directors are most encouraging.

Even before the release of the 8th Directive and other such initiatives around the world, companies were acting themselves to strengthen governance and investor protection. Management has voluntarily improved internal controls and reporting. Directors have taken responsibility for the integrity of financial data. The separate existence of board audit committees has been recognized. There has been a growing emphasis on the role

of non-executive directors in monitoring executives, and new disclosure committees are reviewing the information released to financial markets.

It is this kind of action that will make the increased regulatory oversight all the more effective. Where these initiatives are conducted within an environment of global convergence, directors — and auditors — will be better able to give investors the security they are seeking. ■

*James S. Turley is Chairman and Chief Executive Officer of Ernst & Young, a global professional services firm with 103,000 people in 140 countries. His experience includes working with large and complex global companies, providing merger and acquisition advice and corporate finance and SEC-related assurance services. He frequently works with audit committees and with emerging growth companies.*

## The Directorship Search Group 2004 Corporate Governance Forum Series

### "The Next Phase in Governance"

June 24, 2004

Cherokee Town Club  
155 West Paces Ferry Road, NW  
Atlanta, Georgia

Co-sponsored by



With special support from D<sup>Prime</sup> and Forbes

Register today. Contact Christopher Clark at 203-618-7025  
or email [cclark@directorship.com](mailto:cclark@directorship.com)  
Visit [www.directorship.com](http://www.directorship.com) for full program details

#### Speakers include:

##### DENNIS R. BERESFORD

Ernst & Young Executive Professor of Accounting, J.M. Tull School of Accounting, Terry College of Business, University of Georgia; Director, Legg Mason, Inc., Kimberly-Clark Corporation, and MCI Inc.

##### BLYTHE J. MCGARVIE

President, Leadership for International Finance; Director, Accenture, Pepsi Bottling Group, Travelers Property Casualty Corporation, and Wawa, Inc.

##### WILLIAM V. HICKEY

President & CEO of Sealed Air Corporation; Board Member, Public Service Enterprise Group Inc. and Sensient Technologies Corporation

##### THOMAS E. NOONAN

Chairman, President & CEO, Internet Security Systems; Director of Manhattan Associates, and founder of two technology companies, Actuation Electronics and Leapfrog Technologies

##### DR. JEFFREY A. SONNENFELD

Associate Dean, Executive Programs Yale School of Management, and President and CEO of the Chief Executive Leadership Institute

##### SARAH A.B. TESLIK

Executive Director, Council of Institutional Investors; former corporate and securities attorney with Willkie Farr & Gallagher

##### JAMES E. ROGERS

Chairman, President & CEO, Cinergy Corporation; Director, Cinergy Corporation, Fifth Third Bancorp, and Fifth Third Bank and Duke Realty Corporation

##### JOHN W. KEOGH

President and CEO of National Union Fire Insurance Company of Pittsburgh, PA @; a member company of American International Group, Inc.