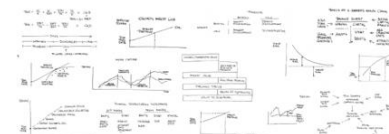


# Corporate Governance

## Part 3

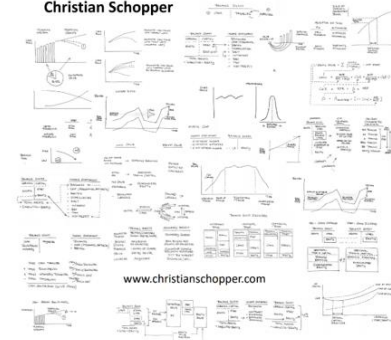
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### Corporate Finance Concepts

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## INFORMATION DISCLOSURE

## An Introduction to Information Disclosure

## Introduction

### Definition and Rationale

- Disclosure is ensuring **access to information** by all interested parties, **regardless of the purpose** of obtaining the information, through a transparent procedure that guarantees information is easily found and obtained

### Principles of Disclosure

**Best Practices:** Good disclosure should be:

1. Provided on a regular and timely basis;
2. Easily and broadly available;
3. Correct and complete; and
4. Consistent, relevant, and documented.

### Confidential Information

- In reality, competitive harm only arises under a **limited number of circumstances**
- In Russia, information is deemed commercially sensitive if:
  - It has real or **potential commercial value** due to its uncertainty to third parties;
  - There is **no free access** to it on legal grounds; and
  - The owner of the information undertakes **steps to keep it confidential**

## Introduction (cont'd)

### Insider Information and Insider Dealing

- Individuals with access to insider information include:
  - Members of the **company's governing bodies** or **securities market professionals** with a contractual agreement with the company;
  - The **External Auditor** of the company or securities market professionals having a contractual agreement with the Auditor; and
  - **Officials** of regulatory agencies having legal rights to control or monitor the company

### Disclosure in Listed Versus Closely Held Companies

- Disclosure requirements are different for publicly listed companies, open and closed joint stock companies, and private companies

### Disclosure Versus Transparency

- **Disclosure** is sometimes **confused with transparency**
- Companies may disclose an enormous amount of **information that is of no particular value** to the users of such information. Important pieces can be withheld...

### Personal Liability for Non-Disclosure

- As a rule, **companies are liable for damages caused to shareholders denied legitimate access to information**
- Members of the company's governing bodies, in particular the **executive bodies**, are **personally liable** for losses caused to the company through their fault

## Disclosure Items

## Best Practices

**Best practices:** The OECD Principles call for disclosure of all material information in the following areas:

- Financial and operating results of the company;
- Company objectives;
- Shareholdings and ownership structure;
- Directors and key executives, as well as their remuneration;
- Material foreseeable risk factors;
- Material issues regarding employees and other stakeholders; and
- Governance structure and policies.

This list is comprehensive, if general. The Technical Committee of the International Organization of Securities Commissions (IOSCO) has developed more detailed, high-level principles for ongoing disclosure and material development reporting for listed entities. These principles are:<sup>23</sup>

- Materiality of information for an investor's investment decision;
- Disclosure on a timely basis — immediate or periodic;
- Simultaneous and identical disclosure in all jurisdictions where the entity is listed;
- Dissemination of information by using efficient, effective, and timely means;
- Disclosure criteria fairness, without misleading or deceptive content and containing no material omission;
- Equal treatment of disclosure — no selective disclosure to investors and others before public disclosure; and
- Compliance with disclosure obligations.

## Financial and Operating Results

### Presenting Financial Information

- Balance sheet
- Income statement
- Statement of changes in owners' equity
- Cash flow statement
- Notes to the financial statements
- Explanations to financial statements
- External Auditor's report

### Preparing Financial Information

- Accrual based accounting,
- Going concern assumption
- Consistency
- Separation of assets and liabilities
- Completeness of information disclosure
- Timeliness
- Conservatism
- Substance over form
- Analytical
- Balance between benefit and cost
- Matching



## Financial and Operating Results (cont'd)

### Disclosing Financial Information

- Financial information will typically be presented in **different forms** and at **different times** throughout the financial year
- **Financial and operating results** will appear in the prospectus, and annual and quarterly reports
- The Law on the Securities Market requires that the following information on the last 5 operating years and the last reporting period be disclosed in these documents:
  - Major areas of company **activity**;
  - **Results** of the financial and business activity, as well as any major factors affecting revenues;
  - Financial and economic **ratios** of the company;
  - Market capitalization, liquidity, and its obligations;
  - Capital structure, including working capital;
  - Composition, structure, and value of fixed assets;
  - Total amount of export; and
  - Inventory of the company's property

## Company Objectives

It is important for markets, shareholders, and other stakeholders to be aware of the company's objectives

- The **communication of company objectives** can be either **in response to legal requirements** or it can be **voluntary**
- Legislation requires that company objectives (such as the **issuance of securities**, **acquisition** plans, replacement and **sales of assets**, or research and development) be disclosed in the **prospectus**
- In addition, **quarterly reports** must contain **forward-looking information** including sources of **revenue**, **plans** for new production procedures, **expansion** or reduction of production, new product development, substitution of old products, modernization or repair of fixed assets, and modification of the types of company activities
- In addition, the **annual report** must outline the company **position in the industry**, priority areas of activity, and development trends

## Major Share Ownership and Voting Rights

### Major Share Ownership

- It is important that shareholders are informed about company **ownership structures** to **understand** their **rights**, **role** and **authority** in governing the company, and influence its policy
- Depending on the size of ownership, shareholders have **varying degrees of influence** over decision-making in a company

Ownership	Influence on decision-making
25% plus 1 vote	The shareholder can block major decisions that require $\frac{3}{4}$ -majority, e.g. to amend the charter or reorganize the company.
50% plus 1 vote	The shareholder can unilaterally take decisions that require a simple majority, e.g. to declare dividends and approve the External Auditor.
75% plus 1 vote	The shareholder can unilaterally decide all issues.

## Ownership Disclosure Thresholds

Threshold	Who Should Disclose	What Should be Disclosed	To Whom and Where to Disclose
One share	Nominal holders	Beneficial owners	Notification to the Registrar of the company. <sup>38</sup>
5% of the charter capital or 5% of common shares <sup>39</sup>	The company	Personal data, the size of the stake in the charter capital, and the amount of common shares, the dynamics of changes in the list of owners of 5% and the size of holdings	To the FCSM. In the prospectus and quarterly reports, and on the company website.
5% of the charter capital or 5% of common shares if shareholders are legal entities	The company	Information on the owners of 20% of the charter capital or common shares in the company-shareholder, as well as the size of the stake in the charter capital and the amount of common shares (chain shareholding)	To the FCSM. In the prospectus and quarterly report, and on the company website.
20% of voting shares	The company	Information on the owners of 20% of voting shares	To the FCSM. In the List of Related Parties and on the company website.
20% and more of securities other than non-convertible bonds <sup>40</sup>	The owner	The holding of securities/the acquisition of securities	To the FCSM, not later than five days after the thresholds are reached; <sup>41</sup> as well as to the antimonopoly body. <sup>42</sup>
20% of voting shares	The legal entity — owner	On legal entities that own 20% of voting shares in the company	To the Supervisory Board, Revision Commission, and External Auditor.
The acquisition of any 5% of securities above 20% as well as the sale of 5% if the remaining stake is higher than 20%	The owner	On the acquisition and/or sale	To the FCSM not later than five days after the thresholds are reached. A special notification form is used for this purpose.
Owning 25% of securities of any type <sup>43</sup>	The company	The holding of securities	To the FCSM. In the material events reports.

## Disclosure of Indirect Ownership, Related Parties et al

	Quarterly Report	Material Events Report	Annual Report	Notification of Regulators and Creditors
Interest of Supervisory Board and executive body members in the charter capital	✓	Acquisition of securities (see Table 2)	✓	Buyback of securities (see Table 2)
Dependent companies with 5% or more participation	✓	Not applicable (n/a)	n/a	n/a
Owners of 20% + of shares in a company – shareholder who, in turn, own 5% + of the company's charter capital or common shares (chain shareholding)	✓	n/a	n/a	n/a
Reorganization of the company, its subsidiaries, or dependent companies	n/a	✓	n/a	To creditors: reorganization of the company
Related party transactions	✓	n/a	✓	n/a
Related parties	Only if related parties are debtors of the company	n/a	n/a	n/a
Acquisition of the company's assets or rights to determine the conditions of the company's business activities	Transactions that impose obligations covering 10% or more of the company's assets	<ul style="list-style-type: none"> <li>• Acquisition of assets entailing a one-time increase/decrease in the value of the company's assets by 10% and more;</li> <li>• A one-time transaction involving 10% and more of the company's assets</li> </ul>	List of extraordinary and similar transactions	<ul style="list-style-type: none"> <li>• Acquisition of assets if their book value exceeds 10% of the book value of the selling company's fixed and/or intangible assets;</li> <li>• Acquisition of rights providing the possibility to determine the conditions of the company's business activity or to act as its executive body</li> </ul>

## Disclosures on Supervisory and Executive Board Members

	Quarterly Report	Annual Report	List of Related Parties	Notification of Regulators
Full name of all individuals	✓	✓	✓	n/a
Current positions	✓	n/a	n/a	Election of an individual into executive bodies and Supervisory Board of two or more companies
Positions for the last five years	✓	n/a	n/a	n/a
Brief biographical data	n/a	✓	n/a	n/a
Kinship of Supervisory and Executive Board members and the Internal Auditor	✓	n/a	n/a	n/a

## Supervisory and Executive Board Members Remuneration

- In Russia, companies must disclose aggregate data on the amount of **remuneration** for **each governing body** during the last completed fiscal year in the prospectus and quarterly report, as well as existing agreements regarding such payments in the current fiscal year

## Material Foreseeable Risk Factors

- Risk (along with return) is one of the most important considerations for any investor
- Risks may include particular **industry** risks as well as **political**, **commodities**, **derivatives**, **environmental**, **market**, and **interest** and **currency** fluctuation risks
- In short, risk is an omnipresent feature of business activity



## Employees and Other Stakeholders

Russian law requires the prospectus and quarterly reports to contain information on the following issues regarding **employees**, **creditors**, and other company **stakeholders**:

- Number of employees, and any material changes in that number;
- General or aggregated data on educational background, composition of personnel, salaries and wages paid, and social insurance;
- Employee share ownership and stock option plans;
- List of debtors whose debts exceed 10% of accounts receivable; and
- Amount and structure of accounts payable.
- Company employees and creditors are further entitled

## Corporate Governance Structures and Policies

### Commitment to Corporate Governance

- Markets are keenly interested in understanding the level of a company's commitment to good governance practices
- They wish to determine whether a company sees governance as a public relations, “**box-ticking**,” or “**window-dressing**” exercise, or whether the company is in fact willing “**to do right**” by shareholders, and to institute and implement real change as necessary and appropriate

### Corporate Governance Structures

- Companies must describe their governance structures, including the **authority of each governing body and internal control mechanisms**, in their prospectus and quarterly reports
- Companies must also describe the procedures for calling and conducting their GMS in these documents, and disclose GMS decisions in material events reports

### Corporate Governance Policies

- Companies should disclose their corporate governance policies, and provide interested users with easy and inexpensive access to this information

## Mandatory Disclosure

## Disclosure During Security Placements

Events	Website Ticker	Mass Media	Corporate Website	Access to Copies
<b>Decision to place securities</b>	One day after the date of the minutes	Not later than five days after the date of the minutes	Not later than three days after the date of the minutes	Within seven days of the request
<b>Decision to issue securities</b>	One day after the date of the minutes	Not later than five days after the date of the minutes	Not later than three days after the date of the minutes	Within seven days of the request
<b>State registration of securities issue</b>	One day after the date of state registration	Not later than five days after the date of state registration	Not later than three days after the date of state registration, incl. prospectus	Within seven days of the request
<b>Start of the placement</b>	Not later than five days before the date of placement	Not applicable (n/a)	Not later than four days before the date of placement	n/a
<b>Completion of the placement</b>	Next day from the date of placement of the last security or the last day of placement	Not later than five days after the date of placement of the last security or the last day of placement	Not later than three days from the date of placement of the last security or the last day of placement	n/a
<b>State registration of the report on the results of the issue</b>	One day after the date of the report's registration	Not later than five days after the date of the report's registration	Not later than three days from the date of the report's registration	Within seven days of the request

## Reports

### Quarterly Reports

- Companies **that have registered a prospectus** must file quarterly reports
- **Signatories** of the Quarterly Report
  - Both the **General Director** and **Chief Accountant** must sign quarterly reports to attest to their reliability and completeness
- **Filing** Quarterly Reports
  - Quarterly reports must be submitted to the FCSM or its regional agencies **no later than 45 days** after the last day of the reporting quarter

### Material Events Report

- Signatories of the Material Events Report
  - The **General Director must sign the material events report**
  - The **Chief Accountant** should **also** sign reports on **material market transactions**, changes in net profits; or changes in company assets
- Codification of Material Events
  - Each material event should be reported separately
- Filing Material Events Reports
  - Companies must file the material events report with the FCSM **within 5 days of the event's occurrence**

## Additional Disclosure

### Information for Shareholders Through the Annual Report

- Companies are obliged to provide shareholders with access to corporate documents, regardless of the number of shares owned

### The List of Related Parties

- All companies must disclose information on related parties on a **quarterly basis**, including personal data, **grounds**, and **duration** of affiliation
- Signatories to the List of Related Parties
  - The General Director must attest to the reliability and completeness of the information included in the list of related parties by signing this list
- Disclosure of the List of Related Parties
  - Companies must submit the list of related parties to the FCSM or its regional agencies no later than 45 days after the last day of the reporting quarter
  - The FCSM is, in turn, required to disclose these lists by posting them on its website
- The List of Related Companies
  - Companies which have securities listed on either RTS or MICEX are additionally obliged to disclose the list of related parties (as well as any changes to the list for at least the last three years) on their corporate website with subsequent notification to the FCSM

## Notification to Regulators

- Companies must notify regulatory bodies such as the FCSM and the Ministry of Antimonopoly Policy and Support of Entrepreneurial Activities

## Notification to Creditors

		Decrease in Charter Capital	Reorganization	Liquidation	Bankruptcy
Form of Notification	Individually	✓	✓	✓	✓
	Via Press	✓	✓	✓	✓
Deadlines		30 days	30 days	not defined	Three days
Responsible Body		General Director	General Director	Liquidation Commission	Bankruptcy Administrator



## Mandatory Disclosure

Details/ Forms	Disclosure during placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees
<b>Responsible person</b>	General Director (GD)	GD after signing by Chief Accountant	GD, and Chief Accountant in particular cases	GD	GD, Corporate Secretary, or specially appointed executives	GD	GD/ Liquidation Commission/ Bankruptcy Administrator	GD or specially appointed executives
<b>Recipients</b>	Any interested person	Any interested person	Any interested person	Any interested person through the FCSM	Shareholders	Interested persons through the FCSM, MAP	Stakeholders/ creditors	Employees
<b>Deadline/ frequency</b>	Next day/within three and five days depending where disclosed	Not later than 45 days after the last day of the reporting quarter	Next day/ within three and five days depending where disclosed	Every quarter	Within seven days upon request/ 20 days prior to GSM	Five days — the FCSM; and 45 days — MAP	30 days, liquidation — not defined	Not applicable (n/a)
<b>Place of disclosure</b>	Website ticker, corporate Website, mass-media	Submission to the FCSM, company's office, corporate website	Submission to the FCSM website ticker, corporate website, mass-media	Submission to the FCSM	Office of the company executive body	Notification of the FCSM and/ or MAP	Publication in mass media and personal notification	Place of employment
<b>Financial and operating results</b>	n/a	Financial statements, ratios, composition of assets/capital	10% and more increase/ decrease of the assets value, large-scale transactions	n/a	Not defined: results of the development	n/a	n/a	n/a

## Mandatory Disclosure (cont'd)

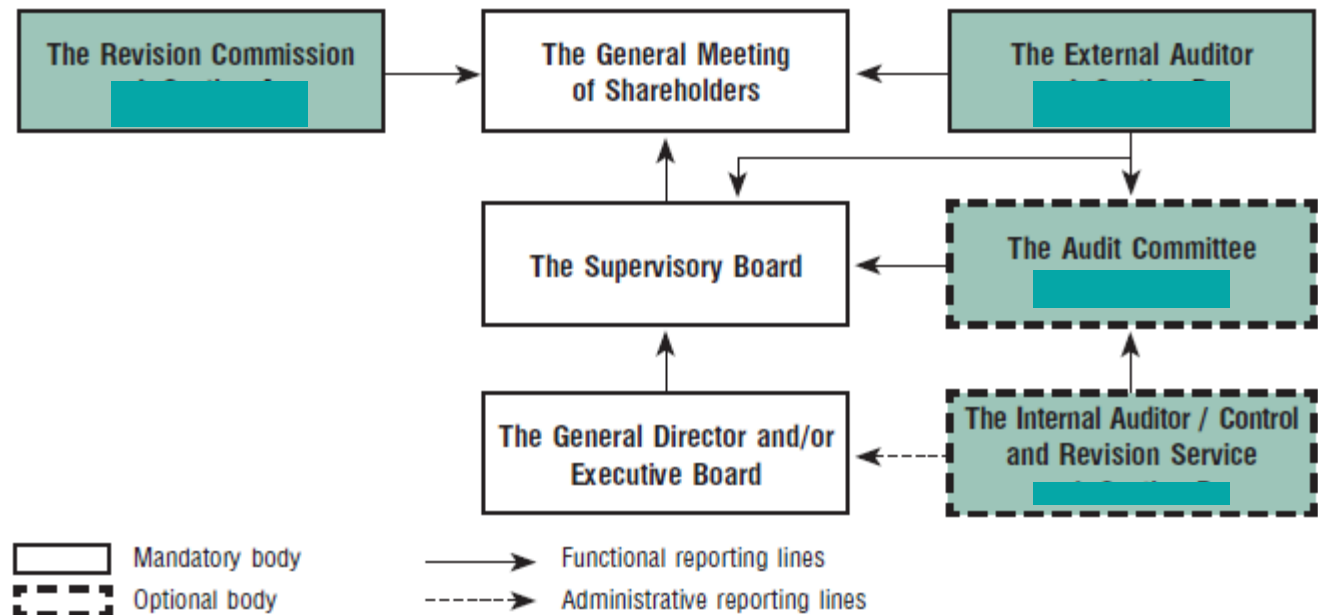
Details/ Forms	Disclosure during Placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees
Company objectives	n/a	Commercial objectives only	n/a	n/a	Commercial objectives and priority activities	n/a	n/a	n/a
Major share ownership and voting rights	n/a	Owners of over 5%, chain shareholding, related party transactions	Owners of more than 25% of the company's securities	List of related parties	Related party transactions	Owners/ acquirers of 20% and more of any type of securities (FCSM+MAP)	n/a	n/a
Supervisory Board and key executives, remuneration	n/a	Info about each member, remuneration in aggregate, size of interest	n/a	Included in the list	Biographical data, share ownership, amount of remuneration in aggregate	Directors and executives holding more than one appointment (MAP)	n/a	n/a
Risk factors	n/a	Risks of industry, region, currency rate fluctuation, other potential risks	n/a	n/a	Major risks affecting activity of the company	n/a	n/a	n/a

## Mandatory Disclosure (cont'd)

Details/ Forms	Disclosure during Placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees
Issues regarding employees and other stakehold- ers	n/a	General information regarding employees, suppliers, debtors, and creditors	n/a	n/a	n/a	n/a	Decrease in the charter capital, reorganization, liquidation	Reorganiza- tion, liqui- dation, tech- nological changes, CPE, foundation documents, collective bargaining agreements
Governance structures and policies	n/a	Authority of each governing body	n/a	n/a	Compliance with recom- mendations of the FCSM Code	n/a	n/a	n/a

## CONTROL AND AUDIT PROCEDURES

## Management Structures and External Agents



## The Revision Commission

## The Composition and Requirements for Members

Revision Commission members **should be independent** of the company's management, and **may not be**:

- A Supervisory Board member;
- The General Director;
- An Executive Board member; or
- A Counting Commission member

**Best Practices:** Revision Commission members should be neither company officials nor Supervisory Board members, the General Director, or an Executive Board member of a competing legal entity.<sup>124</sup>

Generally, Revision Commission members should be chosen based on their financial background and expertise. The Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) advises that only persons with impeccable reputations be elected to the Revision Commission.<sup>125</sup> The charter and by-laws can provide additional requirements for Revision Commission members such as proficiency in accounting and financial reporting.<sup>126</sup>

## Authorities

The Revision Commission has the authority to:

- Conduct an **annual inspection of the company's finances** and operations before the Annual General Meeting of Shareholders (AGM);
- Undertake **extraordinary inspections** of the company's finances and operations;
- Review the **accuracy** of the company's **annual report** and annual financial statements;
- Demand an **Extraordinary General Meeting** of Shareholders (EGM);
- Demand a **Supervisory Board meeting** to discuss items under its authority;
- Request and receive **minutes of Executive Board meetings**;
- Request and receive documents regarding the company's finances and operations from the executive bodies; and
- Request and receive information concerning related parties and related party transactions

**Best Practices:** Additional authorities and duties of the Revision Commission should include the authority to:

- Investigate cases of using insider information;
- Check the timeliness of payments to contractors and mandatory budget payments;
- Check the timeliness of the accrual and payment of dividends, as well as the timely meeting of the company's other financial obligations;
- Check the appropriateness of using the company's reserve and other funds;
- Check the timeliness of payment for the company's issued shares;
- Review the financial condition of the company, specifically its solvency, the liquidity of its assets, and creditworthiness; and
- Oversee the timeliness of the valuation of the company's net assets.



## Reporting

### Inspection Report

- The Revision Commission must **prepare a report** on the results of each annual inspection and present:
  - Its conclusions on the **accuracy** of the company's **operations**, financial **reports**, and other **documents**; and
  - Information regarding any violations of accounting and financial reporting procedures, disclosure rules, and relevant laws and regulations

### Presenting the Inspection Report

- The Revision Commission's conclusions should be **attached to the company's annual report**
- Because the Supervisory Board must preliminarily approve the annual report no less than 30 days before the AGM, it is good practice for the Revision Commission to give the Supervisory Board at least ten days to review and discuss the inspection report
- Thus, the Revision Commission should submit their inspection report to the Supervisory Board at least 40 days before the AGM
- The annual inspection report must also be distributed to shareholders as a separate document before the AGM

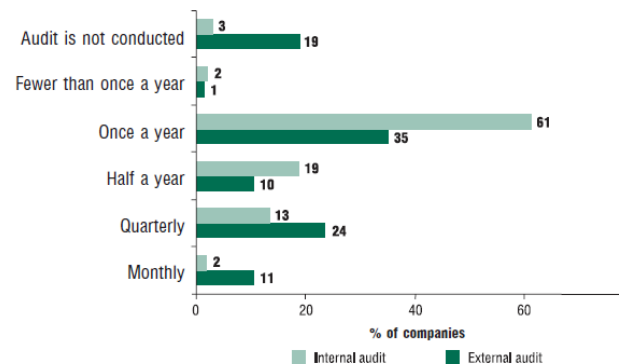
## The Independent External Auditor

## When an Annual Audit Is Required

The federal law *On Audit* prescribes criteria for obligatory statutory audit:

- Open joint stock companies
- Banks, insurance companies, stock exchanges, and investment institutions
- State municipal, unitary enterprises
- Companies with revenues and/or total assets exceeding a certain limit as of the end of year preceding the reporting period
  - Currently, revenue for the year >RUB 50 million (about US\$1.657 million) and total assets >RUB 20 million (US\$662,000)
- Other cases when federal laws stipulate mandatory audit

### Frequency on Internal and External Audits



## The Rights and Duties of the External Auditor

### The External Auditor has the authority to:

- Determine the method of conducting the audit;
- Examine the documentation, as well as uncover and confirm assets of the company;
- Receive oral and written explanations on any issues that arise during the audit;
- Refuse to carry out the audit or provide an opinion about the reliability of financial statements if the company does not provide all required documents or when circumstances arise that have an effect on the Auditor's opinion;
- Have access to the charter, including amendments and any restated charter;
- Request an EGM;
- Request a Supervisory Board or an Executive Board meeting;
- Receive minutes of Executive Board meetings;
- Receive information from interested parties on related parties and related party transactions; 166 and
- Provide other services as specified by legislation

### The External Auditor must:

- Carry out the audit in conformity with Russian (and any applicable foreign) laws;
- Provide the company with relevant information on the legal requirements for conducting the audit, as well as any legal acts on which the comments and conclusions of the External Auditor are based;
- Provide the audited company with the audit report within the time specified by the contract between the External Auditor and the company;
- Ensure the safekeeping of documents received or developed during the audit, and not permit the disclosure of the contents of these documents to any unauthorized persons without the consent of the company, except when such disclosure is required by law; and
- Carry out other duties that derive from the nature of the legal relationship specified by the contract between the External Auditor and the company, as long as such duties do not contradict Russian (and any applicable foreign) laws

## The Rights and Duties of the Company

### The company has the right to:

- Receive from the External Auditor relevant information on the legal requirements related to the audit, as well as any legal acts on which the comments and conclusions of the External Auditor are based;
- Receive the audit report within the time specified by the contract between the External Auditor and the company; and
- Exercise other rights that derive from the nature of the legal relationship specified by the contract between the External Auditor and the company, as long as the existence of such rights does not contradict Russian (and any applicable foreign) laws

### The audited company is obligated to:

- Conclude a contract with the External Auditor for carrying out the statutory audit within the time specified by Russian law;
- Assist the External Auditor in every way in successfully completing the audit, including: providing all necessary information and documentation, furnishing full explanations and confirmations, and, when necessary, securing information from third parties;
- Not hinder the successful completion of the audit in any way;
- Pay for the External Auditor's services, even when the conclusions of the audit report conflict with the opinions of the company's officials; and
- Carry out other duties that derive from the nature of the legal relationship specified in the contract between the External Auditor and the company, as long as such duties do not contradict Russian (and any applicable foreign) laws


### Who Can Be an External Auditor

- Any individual certified as an individual auditor, or a legal entity with a license to perform auditing services, can be an External Auditor

**Best Practices:** In the U.S., the 2002 Sarbanes-Oxley Act prohibits public accounting firms from providing non-audit service to their audit clients including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board of Directors determines, by regulation, is impermissible.<sup>180</sup>

An exception to this rule is made should non-audit services that are not listed above be pre-approved by the Supervisory Board's Audit Committee. The Audit Committee should, however, disclose these services to investors in periodic reports. Another exception is made when the non-audit services constitute less than 5% of the total amount of revenues paid to its auditor, these services were not recognized to be non-audit services at the time of engagement, and the Audit Committee promptly approves these services prior to the completion of the audit.

### The Contract with the External Auditor

- The company must enter into a contract with the External Auditor once he has been approved by the GMS

## Reporting

The External Auditor **presents conclusions** on the reliability of the company's financial statements and compliance with accounting procedures

- The **opinion paragraph** of the auditor's report should state the auditor's opinion as to whether the financial statements give a **true and fair** view (in all material respects) in accordance with the financial reporting framework used by the company and, where appropriate, whether the financial statements comply with statutory requirements
- The External Auditor must prepare a report on the annual audit

### The External Auditor's Liability

- Since the External Auditor is liable for civil, administrative, and criminal infractions, he should be adequately **insured** by a reputable (domestic or international) insurance provider with appropriate coverage
- **Civil Liability**
  - The grounds and terms of civil liability are usually specified in the contract between the External Auditor and the company
- **Administrative Liability**
  - The Law on Auditing states that the External Auditor bears administrative liability if he provides the company with an obviously false opinion, with the license potentially be revoked
- **Criminal Liability**
  - The Criminal Code stipulates that when the External Auditor uses his authority for his own purposes and violates the rights of a company or related parties, the External Auditor may be prosecuted

## The Audit Committee



## The Three Main Areas of Focus for the Audit Committee



## Functions

The Audit Committee should:

- Develop **recommendations** for the Supervisory Board **on selecting** an **External Auditor**
- **Interact** with the company's External Auditor and Revision Commission;
- **Control** financial and business **operations**, and oversee the **implementation** of the financial and business plan of the company;
- Monitor the Control and Revision Service;
- **Evaluate** the **efficiency** of internal control procedures;
- Develop internal control and risk management procedures in cooperation with management; and
- Develop recommendations for the Supervisory Board's approval of nonstandard operations

## Modus Operandi

### Composition

- The charter should set forth **special professional qualifications** for Audit Committee members
- Of particular importance is that members have relevant and real **expertise** in accounting and financial reporting

### Meetings

- If a Supervisory Board meeting considers matters pertaining to Audit Committee activities, a meeting of the Audit Committee should take place before the Supervisory Board meets

### Access to Information and Resources

- The Supervisory Board should be provided with **information** on the financial and operating results of the company
- In addition, Audit Committee members will need to have unfettered **access** to **documents** and corporate information to allow them to fulfill their functions
- The Corporate Secretary often plays a crucial role in this respect, facilitating a free flow of information

## Internal Control Function

## Internal Control Principles

A company's internal control system should be based on the following principles:

- The internal control system should **function** at all times and without interruption
- Each person involved in the internal control process should be held **accountable**
- The internal control system should **segregate duties**
  - Companies should prohibit duplication of control functions, and should distribute functions among the employees so that one and the same person would not combine functions relating to the authorization of operations with certain assets, recording of such operations, ensuring and safe-keeping of assets, and inventory of these same assets;
- Proper **authorization and approval of operations**
  - Companies should establish procedures for approving financial and business operations by authorized persons, within the scope of their authority;
- Companies should ensure the organizational **separation** of its subdivision responsible for **internal control**, and moreover, ensure that this subdivision is **accountable directly to the Supervisory Board** (commonly through its Audit Committee).
- All units and departments of the company should integrate and cooperate to allow the internal control system to be properly implemented;
- A culture of continuous development and improvement needs to be put in place
  - A company's internal control system should be structured to allow it to flexibly address new issues, and easily be expanded and upgraded; and
- A system for timely reporting on any deviations should be put in place

## Elements of the Internal Control System

### Control environment

- The control environment sets the tone of an organization, and influences the control consciousness of its people

### Risk assessment

- Every entity faces a variety of risks from external and internal sources

### Control activities

- Control activities are the policies and procedures that help ensure that management directives are carried out

### Information and communication

- Pertinent information must be identified and communicated in a form and within a timeframe that enables employees to carry out their responsibilities

### Monitoring the efficiency of the internal control system

- Internal control systems need to be monitored over time in order to assess the quality of the system's performance

## Internal Auditing

### Typical internal audit tasks

- Appraise compliance of business activities with internal policies and procedures;
- Provide advice in setting up internal policies and procedures;
- Appraise controls over the safeguarding of assets;
- Appraise compliance with laws and regulations;
- Appraise internal controls over financial information;
- Appraise internal controls over business processes;
- Appraise the process for identifying, evaluating, and managing business risks;
- Appraise operational efficiency;
- Appraise compliance with contractual obligations;
- Conduct audits of information technologies;
- Investigate fraud; and
- Audit of subsidiary companies

## The Control and Revision Service

### Authorities

- Develop policies and procedures for internal control in cooperation with the executive bodies and Audit Committee;
- Attend those meetings of the Audit Committee in which implementation of the finance and business plan, compliance with internal control and risk management procedures, and the approval of non-standard operations are discussed;
- Examine documents and materials regarding their compliance with internal control procedures, including the existence of required approvals of relevant department heads, as well as the existence of funds in the financial and business plan sufficient for fulfilling certain operations;
- Exercise daily control over the financial and business activities of the company;
- Analyze and evaluate non-standard operations and prepare recommendations for the Supervisory Board; and
- Help the Audit Committee to obtain information

### Reporting

To be effective, should report directly to the Audit Committee

### Composition

- The head of the Control and Revision Service and not less than 2/3 of his staff should hold a higher degree in the fields of finance, accounting, business, law, or economics



## Summary of Audit Functions

	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
<b>Status</b>	A controlling body of the company, independent from management	A certified auditor, typically an audit firm, that is independent from management and major shareholders	A committee of the Supervisory Board	Typically, an employee or a subdivision of the company
<b>Main Functions:</b>	<ul style="list-style-type: none"> <li>• Conducts annual inspections of financial and business activities;</li> <li>• Conducts extraordinary inspections; and</li> <li>• Reviews the annual report and financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• Audits the financial statements prepared and presented by the company; and</li> <li>• Conducts extraordinary audits.</li> </ul>	<ul style="list-style-type: none"> <li>• Develops recommendations for the Supervisory Board on the selection of the External Auditor;</li> <li>• Interacts with the External Auditor and Revision Commission;</li> <li>• Oversees financial and business operations of the company;</li> <li>• Oversees the budget process;</li> <li>• Works with the Internal Auditor and/or Control and Revision Service;</li> <li>• Supervises the development of the internal control and risk management procedures;</li> <li>• Develops recommendations for the Supervisory Board's approval of "non-standard operations;" and</li> <li>• Liaises between all auditing functions, both internal and external.</li> </ul>	<ul style="list-style-type: none"> <li>• Develops policies and procedures for internal control;</li> <li>• Ensures compliance with policies and procedures, as well as with local laws and regulations;</li> <li>• Designs and operates controls to safeguard assets, and over financial and business data; and</li> <li>• Assists in enhancing the efficiency of operations.</li> </ul>
<b>Reports to:</b>	Shareholders	Shareholders via the Supervisory Board or its Audit Committee	The Supervisory Board	The General Director and/or the Financial Director administratively and the Supervisory Board's Audit Committee functionally

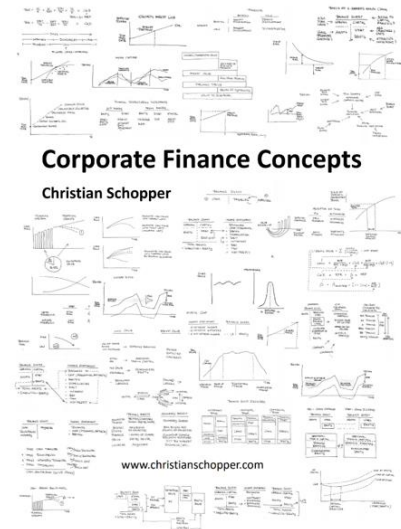
## Summary of Audit Functions (cont'd)

	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
<b>Regulated by:</b>	The Company Law	Accounting and audit legislation, the Company Law, and the contract with the company	The charter, by-laws, internal documents, and employment contracts	The charter, by-laws, internal documents, and employment contracts
<b>Liabilities:</b>	Civil and labor legislation, employment contracts	Civil and audit legislation, civil contracts	Civil and labor legislation, employment contracts	Internal documents, labor legislation, employment contracts
<b>Composition:</b>	Supervisory Board members and executive bodies cannot be members. Members may be employees or shareholders of the company	The External Auditor must be independent from the company in all respects	Audit Committee members should be independent directors	Staffed by company employees

## Contact

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