Internal Control in Corporate Governance Codes
- a comparative study

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ABSTRACT
Increased harmonization creates a need for understanding the commonalities and differences between national practices. Over the past decade, interest has increased in the role that corporate governance plays in economies, particularly in capital markets, in the European Union and its member states. A special group of corporate governance recommendations has come up in the past decade, called governance codes, and almost all member countries now have their own code. The Swedish Corporate Governance Code has not yet been set into practice, but already it has been criticized for not providing enough guidance regarding internal control.

The purpose of this thesis is to compare the internal control aspect in the Swedish Corporate Governance Code, to equivalent documents issued by other EU member states, in order to identify similarities and discrepancies. By doing this, we are hoping to contribute with some knowledge about a few of the barriers that might be of importance when developing a single EU capital market. The study is based on a comparative method with content analysis characteristics. The codes were analysed using four empirically generated key concepts: Definition, Objective, Responsibilities and Report.

Given the different origins of the corporate governance codes analysed in this thesis, they are remarkably similar, especially in the attitudes they express about responsibilities. Of course there are differences, yet mainly trivial. Imagining a design of a uniform EU corporate governance code, we believe the identified differences to be insignificant, since the internal control sections in the codes generally differ more in form than in substance.
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1. Introduction

This chapter contains a brief introduction to the background and the problems that constitute the foundation of this thesis. Thereafter the purpose is presented along with the disposition of the thesis.

1.1. Background

“Over the past decade, interest in the role that corporate governance plays in economies, and particularly in capital markets, has increased in the European Union and its Member States.”\(^1\) The growing interest in corporate governance codes among EU member states “may reflect an understanding that equity investors, whether foreign or domestic, are considering the quality of corporate governance along with financial performance and other factors when deciding whether to invest in a company.”\(^2\)

Corporate governance can be defined in a variety of ways; but “when talking about corporate governance we usually mean the structures, processes, cultures and systems that make up an organisation”.\(^3\) One important part of corporate governance is internal control. Internal control is broadly defined as a process, designed to provide reasonable assurance regarding the achievement of for example compliance with applicable laws and regulations and reliability of financial reporting.\(^4\) It also includes procedures designed to increase the organization’s efficiency, ensure that its policies are implemented, and its assets are safeguarded.\(^5\) No internal control system can entirely prevent events leading to unexpected losses or unintentional misrepresentations of operational facts, but the establishment of an effective internal control system is a key aspect of good corporate governance.\(^6\)

The European countries are becoming more and more harmonized, for example through the European currency (Euro) and the recently adopted common accounting standards (IAS/IFRS).

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Capital, goods, services and people are now flowing freer across EU borders than ever. This harmonization creates a need for understanding the commonalities and differences between national practices, which might be barriers to the development of a single EU capital market.\(^7\) Differences in corporate governance practices; financing traditions, ownership structures et cetera, could be such barriers. These corporate governance practices are often to be found in so-called corporate governance codes. A corporate governance code is generally defined as a “non-binding set of principles, standards or best practices, issued by a collective body, and relating to the internal governance of corporations.”\(^8\) The development of corporate governance codes in EU member states dates to the early 1990’s\(^9\) and almost all member countries now have their own corporate governance code. Sweden presented their corporate governance code in December 2004.\(^10\)

1.2. Problems

The Swedish code has not yet been set into practice, but already it has been criticized for not providing enough guidance regarding what good internal control really means. Anders Hult, partner at Deloitte, and Michael Bernhardtz, senior manager at Deloitte, says in an article in Dagens Industri\(^11\) that they believe that the lack of definition of internal control could lead to the establishment and assessment of several different varieties of controls. This critique, as well as the ongoing harmonization, creates an interest for how the codes of our fellow EU members look; do they mention internal control in these documents? If so - are there any clear definitions of internal control? It is obvious that with increased collaboration between companies in the European Union, comprehensible and perspicuous rules and regulations are of great importance. If there are no definitions of internal control in the different codes - is it possible to assess whether they are designated to the same objectives? What other similarities and discrepancies, regarding internal control in the codes, are of interest? In this perspective, what could the problems be in an attempt to harmonizing these codes?

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\(^{7}\) Weil, Gotshal & Manges, p.1
\(^{8}\) Weil, Gotshal & Manges, p.1
\(^{9}\) Weil, Gotshal & Manges, p 8
\(^{11}\) Bernhardtz & Hult, Otydligt om intern kontroll, (Dagens Industri, 2004)
1.3. Purpose
The purpose of this thesis is to compare the internal control aspect in the Swedish Corporate Governance Code, to equivalent documents issued by other EU member states, in order to identify similarities and discrepancies. By doing this, we are hoping to contribute with some knowledge about a few of the barriers that might be of importance when developing a single EU capital market.

1.4. Disposition
The next chapter describes the methodology used; a comparative study with qualitative content analysis characteristics. Chapter three includes a definition of internal control and in the same chapter we also discuss the ongoing harmonization within the EU. Thereafter chapter four contains a summary of the internal control paragraphs in the Swedish Code of Corporate Governance. A thorough background to the development of the Swedish code is to be found in the Appendix 1. Chapter four also contains empirical compilations of the Swedish corporate governance codes and 13 other European corporate governance codes, using four key concepts. The fifth chapter presents the similarities and discrepancies in the codes and an analysis of these. The conclusions drawn from this analysis can be found in chapter six.
2. Method

This chapter starts with a definition of corporate governance code, which is followed by a presentation of the methodology used. The chapter also describes the procedures taken when gathering information and performing the content analysis. At the end of the chapter, limitations and source criticism are presented.

2.1. Definition of Corporate Governance Code

The volume of material concerning corporate governance is immense: articles, dissertations, laws, regulations and more. “Within this vast literature, a unique group of corporate governance recommendations has arisen in the past decade, loosely called governance “codes,” “principles” or “guidelines.””\textsuperscript{12} It is upon these kinds of documents that this thesis has been built. In a comparative study of corporate governance codes relevant to the EU, and its member states, commissioned by the European commission, a corporate governance code is defined as a “non-binding set of principles, standards or best practices, issued by a collective body, and relating to the internal governance of corporations.”\textsuperscript{13} This is also the definition that we have used in this thesis since it is beyond its extent to create a new definition.

2.2. Comparative Study

This study is based on a comparative method, which is a comprehensive term used to describe studies aimed at describing and analysing differences and similarities between study objects.\textsuperscript{14} A possible disadvantage with comparative studies could be that by comparing objects to each other, you receive no indication of which object, if any, is the superior. On the other hand, comparative studies are a simple and structured way to identify similarities and discrepancies between objects. Comparative studies can be divided into three categories depending on the aim of the study: describing, explaining or predicting.\textsuperscript{15} Our study is both descriptive and predictive, since we aim at describing the similarities and discrepancies regarding internal control in different corporate governance codes as well as predicting how these differences might matter in a design of a uniform European corporate governance code.

\textsuperscript{12} Weil, Gotshal & Manges, p.10
\textsuperscript{13} Weil, Gotshal & Manges, p.1
\textsuperscript{14} http://www.ne.se/jsp/search/article.jsp?i_sect_id=218434
\textsuperscript{15} Denk, Thomas, \textit{Komparativ metod – förståelse genom jämförelse}, 2002, p.8
The focal point from which we started our study is the Swedish Code of Corporate Governance. This because we thought that the best way to make a comprehensible comparison would be to position one country’s code as a reference and compare the codes of the other countries to that particular one, and Sweden seemed the natural choice considering our origin. By comparing the Swedish corporate governance code to the codes of other countries, we also create opportunities to compare the other countries’ codes to each other.

2.3. Content analysis

"Content analysis is a research tool used to determine the presence of certain words or concepts within texts or sets of texts."\(^{16}\) Quantitative content analysis seeks to break communication texts into observable and recordable units, such as words, themes and characters and produce findings which are replicable, generalizable and measurable.\(^{17}\) This is often done by establishing the existence and frequency of concepts in a text. We rejected this classic quantitative content analysis in this paper because it was not suitable for the texts we worked with. Instead the study has the characteristics of a qualitative content analysis, with simple definitions of what we want to measure. After reading through the Swedish code thoroughly we recognized that the code focuses on three main concepts: Objective, Responsibilities and Report. In order to make our analysis of the other codes comprehensible, we chose to work with these empirically generated key concepts. We also added a fourth concept: Definition, even though it does not exist in the text at all. This concept was added due to the criticism that the Swedish code has received for its lack of a definition of internal control and we found it interesting to see whether the other countries have a definition of internal control or not.

**Definition**

What we have looked for is a definition of internal control, for example if *internal control* is followed by “*i.e. systems to…*” that is considered a definition.

\(^{16}\) [http://writing.colostate.edu/references/research/content/pop2a.cfm](http://writing.colostate.edu/references/research/content/pop2a.cfm)

\(^{17}\) [http://www.unc.edu/courses/2000fall/jomc245-001/content_analysis.html](http://www.unc.edu/courses/2000fall/jomc245-001/content_analysis.html)
**Objective**

Within this key concept we searched the text for objectives with internal control. We have excluded all text regarding objectives of for example certain auditing boards et cetera and focused on whether the code explains *why* the company should have internal control.

**Responsibilities**

Responsibilities could be of different kinds; responsibility for putting internal controls in place, responsibility for managing internal controls, responsibility for reviewing the system of internal control et cetera. We have within this category of the analysis examined *who* is responsible for *what*.

**Report**

We have defined a report as any kind of document, regarding the company’s internal control, which needs to be produced for external use, by any party within the company. In this paper shareholders are considered an external part. We have chosen not to go into detail considering the specific contents and designs of the reports.

**2.4. Procedure**

In this study we have focused on the corporate governance codes published by the EU member states. To identify codes published in these countries we primarily used the Internet. We started our search using the search engine Google. First we searched using the words *internal control* and *corporate governance*, but these searches gave us millions of results so to make our search more specific we used *corporate governance codes*. This also yielded numerous results (850,000), but the top two results got our immediate attention since they were links to www.ecgi.org, The European Corporate Governance Institute (ECGI). ECGI is an international scientific non-profit association, founded in 2002. The Institute is making available, through their website, “…the full texts of corporate governance codes, principles of corporate governance and corporate

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18 As of May 1st 2004, the 25 member states of the EU are: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, the Netherlands and the United Kingdom. (http://www.geography.about.com/library/maps/bleu.htm)

19 http://www.ecgi.org/organisation/about_ecgi.htm

20 http://www.ecgi.org/organisation/overview.htm
governance reforms both in Europe and elsewhere."\(^{21}\) On this website we could find corporate governance codes published in 22 of the 25 EU member countries. We could not find any corporate governance codes published by Estonia, Latvia or Luxembourg. Since we could not find these codes on the ECGI website we continued our search on the Internet. We found that Estonia have not yet published a corporate governance code. A draft for a corporate governance code was presented on March 15, 2005; however, this draft is yet only to be found in Estonian.\(^{22}\) We also found that Latvia has published a document called “Report on the Observance of Standards and Codes (ROCS) – Corporate Governance Assessment”\(^{23}\). We could not find that Luxembourg have any corporate governance code or similar document.

We searched through the 23 codes found, for the words *internal control* to see if, and how, the respective countries treat the concept of internal control. The results were varying; in some codes there was nothing about internal control, while in others it was mentioned in several places. Austria, Germany, Ireland, Latvia, Lithuania, Poland and Portugal do not mention internal control at all in their codes. Neither does the French corporate governance code. It does mention *internal procedures*, but we have not regarded this to be exactly the same as *internal control*. As for the Spanish corporate governance code, we could only find a Spanish version of it and we were therefore unable to see whether it mentions internal control or not.

In the end we had 14 corporate governance codes that contained regulations regarding internal control: Belgium, Cyprus, Czech Republic, Denmark, Finland, Greece, Hungary, Italy, Malta, Slovakia, Slovenia, Sweden, the Netherlands and the United Kingdom, see table 1.

\(^{21}\) http://www.ecgi.org/codes/index.php
\(^{22}\) http://www.fi.ee/?id=2206 and Tex Vertmann, 2005-06-02
<table>
<thead>
<tr>
<th>Country</th>
<th>Code</th>
<th>Internal control</th>
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<td>X</td>
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<tr>
<td>Austria</td>
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<td>Belgium</td>
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<td>Cyprus</td>
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<td>Czech Republic</td>
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<td>Denmark</td>
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<tr>
<td>Estonia</td>
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<td>a) Draft only. In estonian.</td>
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<tr>
<td>Finland</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>France</td>
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<td>b) Internal procedures.</td>
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<tr>
<td>Germany</td>
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<td>Greece</td>
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<td>Slovenia</td>
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<tr>
<td>Spain</td>
<td></td>
<td>c) In Spanish only.</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>X</td>
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</tr>
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<td>The UK</td>
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</tr>
</tbody>
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Table 1: Summary of the occurrence of corporate governance codes in the EU member states, and whether internal control regulations is present in these documents.  
Source: Authors’ own compilation.

The countries without a corporate governance code will not be considered in the empirical compilation of the codes in chapter 4. Nevertheless, they will be included in the analysis and conclusions.

2.5. Limitations  
We have chosen not to go into detail about corporate governance in this thesis, since that would make it far too extensive. Internal control is one important part of corporate governance and we focus on this part solely.

This study is limited to comparing the Swedish corporate governance code with similar documents issued by EU member states. The main reason for focusing only on EU member states
is, as mentioned in the introduction and purpose sections, the harmonization that is taking place within the EU. We have chosen only to include one corporate governance code for each country studied. Most of the European countries studied have several corporate governance documents published (codes, drafts, addendums, revised documents, handbooks et cetera). We have used the most recent code or principles document. However, when analysing the Cypriot corporate governance code, we have used both the Corporate Governance Code and the Addendum of the Corporate Governance Code. This because the Addendum of the Corporate Governance Code is the most recent corporate governance document presented by Cyprus, however it does not contain the full text of the corporate governance code.

When we analyse the key concept responsibility of internal control, in the respective codes, we want to focus on the different levels of the organisations rather than specific functions. We have therefore chosen to regard some bodies of the board (supervisory board, board of directors, audit committee) as the Board. Executive board and management board on the other hand has been regarded as Management since these most often consist of the CEO (Chief Executive Officer) and CFO (Chief Financial Officer).

2.6. Source Criticism
The main source of information for this paper has been the Internet. When using information from the Internet it is essential to critically review the credibility of the source. For instance, who has published the information and why? When was the site updated and for who is the information intended?

As for the ECGI information, the codes “come from various sources: some have originated from other publicly accessible websites; others have been submitted by their issuing institution; and many have been sent by ECGI members and others”.24 Information is published to contribute to “a forum for debate and dialogue between academics, legislators and practitioners, focusing on major corporate governance issues and thereby promoting best practice.”25 During the process of writing this paper the ECGI website has been updated several times, most recently the 29th of

24 http://www.ecgi.org/codes/index.php
25 http://www.ecgi.org/organisation/overview.htm
April 2005. To see if the codes presented on the ECGI website are authentic and up to date, we have searched for the codes on national websites of the respective countries. As a few examples, we found the Swedish code on a Swedish government website\textsuperscript{26}, the Belgian code on the Belgian Corporate Governance Committee’s website\textsuperscript{27} and Denmark’s report on a Danish Corporate Governance website\textsuperscript{28}. We have therefore chosen to trust that the information presented on the ECGI website is accurate, even though ECGI does not own the copyright, nor guarantee the accuracy or completeness of the information.\textsuperscript{29} In the same manner as with the ECGI website, we have adopted a critical attitude towards the other Internet sources.

Since we have used the English versions of the codes, we are aware of the possibility that these translated documents might not accurately reflect the original documents.

Two printed sources and one Internet source are in Swedish: The article “\textit{Otydligt om internkontroll}” from Dagens Industri, the book “\textit{Komparativ metod – förståelse genom jämförelse}” by Thomas Dent and the website www.ne.se, “Nationalencyklopedins internettjänst”. We have translated this information into English and we are aware that there is a minor possibility of our translation being inaccurate. However, the sources are scarcely used and do not effect the results of this study.

\textsuperscript{26} http://www.regeringen.se/content/1/c6/03/99/53/1a95fd96.pdf  
\textsuperscript{28} http://www.corporategovernance.dk/object.php?code=1&obj=40029&code=1  
\textsuperscript{29} http://www.ecgi.org/codes/index.php
3. Theoretical Background

In this chapter we will give a summary of the most well known definition of internal control. This definition is presented by COSO (The Committee of Sponsoring Organizations of the Treadway Commission) and we will therefore start by giving an introduction to this organization. Later on in the chapter we will discuss harmonization of corporate governance regulations, within the EU.

3.1. Internal Control

3.1.1. COSO and the COSO Framework

COSO was formed in 1985 to sponsor studies on the causal factors that can lead to fraudulent financial reporting. In 1992 COSO issued the report *Internal Control – Integrated Framework*, “to help businesses, and other entities, assess and enhance their internal control systems.” In 1994, the framework was amended to expand the scope of safeguarding of assets. According to COSO, that framework “has since been incorporated into policy, rule, and regulation, and used by thousands of enterprises to better control their activities in moving toward achievement of their established objectives.” Others also seem to consider COSO and its framework to be of great importance. The Financial Executives Internationals research foundation (FERF) says, “Since its inception, the COSO alliance has been a strong, respected voice in the business community. The alliance was the first to define internal control and develop a useable framework for assessing and developing an internal control structure.” Protiviti, an independent risk consulting firm, presents the model, for evaluating internal control, in the framework as the model that has been ”adopted as the generally accepted framework for internal control” and says that the model ”is widely recognized as the definitive standard against which organizations measure the effectiveness of their systems of internal control.”

According to the COSO framework, internal controls are put in place to help the company reach profitability goals and achieve its missions, but also to minimize surprises along the way. An internal control system enables management to deal with quickly changing economic and financial conditions.

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30 http://www.coso.org
31 http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf, p V
33 http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf, p V
34 http://www.fei.org/iafreewebsite.nsf/content/COSOInternalControlFramework?OpenDocument
competitive environments, market changes such as shifting customer demands and priorities, and restructuring.37

So what is then internal control? There seems to be no distinct answer to that question. It could mean different things to different people, which could be a factor of confusion among business people, legislators, regulators and others. Misunderstandings and different expectations could easily lead to problems within organisations, and problems can get even more apparent when the term, if not clearly defined, is written into laws, regulations and/or other official documents. The COSO report deals with the needs and expectations of managers and others, and describes internal control in order to establish a common definition that serves the needs of different parties, and to provide a standard against which organizations can assess their control systems and determine how they can be improved. This report reflects a process of many years of growing awareness of the importance of internal control.38

According to the COSO report everyone in the organization is responsible for the internal control, yet in different ways. Management is responsible for establishment of internal control policies and procedures. Management is accountable to the Board of Directors, which is responsible for providing governance, guidance and oversight. All Personnel should be responsible for reporting problems, such as policy violations or illegal actions, in operations.39

3.1.2. Definition of Internal Control

"Internal control is broadly defined as a process, affected by an entity’s board of directors, managers and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations."

Table 2: Definition of internal control, from the COSO framework.

38 Vaassen, Accounting Information Systems – A Managerial Approach, (Chichester, 2002), p. 20
In 1994, the objective of safeguarding of assets was added by the Committee to form a part of all the other three objectives of internal control.\textsuperscript{40}

The quoted definition above echoes certain fundamental concepts, for example, internal control is a \textit{process}, a means to an end, not an end itself. Furthermore, internal control is affected by \textit{people}, not only policy forms and manuals, internal control can be expected only to provide \textit{reasonable}, not absolute, assurance to an entity’s management and board, and, finally, internal control is equipped to deal with the achievement of \textit{objectives} in one or more separate but overlapping categories.\textsuperscript{41}

\textbf{3.2. Harmonization of Corporate Governance Regulations within the EU}

The European Union is in constant change, as well as growth, as more and more countries are welcomed as members. Today 25 countries, with different cultures and traditions, shall cooperate and agree on political and economical issues. The EU is furthermore becoming harmonized for example through the European currency (Euro) and the recently adopted common accounting standards (IAS/IFRS). In the area of corporate governance, the European Commission has in the recent years taken a number of measures towards harmonization. In May 2003, the Commission presented an Action Plan \textit{“The Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward”}. The Action Plan is intended to “help shape international regulatory developments”\textsuperscript{42} and “devotes special attention to a series of corporate governance initiatives aiming at boosting confidence on capital markets”\textsuperscript{43}

The European Commission states in a press release, in May 2003, that “The European regulatory framework for company law and corporate governance needs to be modernised for several reasons […] the growing trend for European companies to operate cross-border in the Internal Market, the continuing integration of European capital markets, […], the forthcoming enlargement of the EU to 10 new Member States, and the damaging impact of recent financial

\textsuperscript{40}Vaassen, (2002), p. 20
\textsuperscript{43}http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/03/716&format=HTML&aged=1&language=EN&guiLanguage=en
scandals.”  The Commission does not believe that a self-regulatory market approach, based solely on non-binding recommendations, is sufficient to guarantee sound corporate governance, and therefore thinks that the EU should adopt a common approach covering a few essential rules and ensure adequate coordination of national corporate governance codes.

A European Corporate Governance Forum was set up, in October 2004, by the European Commission, “to examine best practices in Member States with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission.” Internal Market Commissioner Frits Bolkestein said, at the High Level European Corporate Governance Conference organized by the Dutch Presidency in The Hague, in October 2004: “The time is ripe for this initiative, as many Member States are reviewing their own corporate governance codes. This work is not a precursor for a European corporate governance code, but it is a drive to raise standards across the board.” Bolkestein also noted that “what the European Union does has an impact on U.S. markets just as the Sarbanes-Oxley Act has had a profound impact in the EU.”

Another step on the way towards harmonization is that the European Commission, in October 2004, proposed that all listed EU companies should provide a corporate governance statement in their annual report. That statement would, among other things, cover whether the company complies with a corporate governance code.

One of the most recent actions was when the European Commission, in April 2005, set up an expert advisory group to provide detailed technical advice on preparing corporate governance and

company law measures. The work of this group will be “complementary to the more strategic role in the convergence of corporate governance in Europe carried out by the recently created European Corporate Governance Forum.”

4. Empirical compilation

In this chapter we will present the paragraphs in the Swedish corporate governance code regarding internal control, and also a compilation of these, using the four key concepts presented in the methodology. The last part of this chapter contains compilations of 13 European Union member states corporate governance codes, using the same key concepts and a summary of these compilations.

4.1. Internal Control in the Swedish Code of Corporate Governance

The Swedish corporate governance code was published in December 2004.\textsuperscript{51} It contains a number of rules and regulations regarding corporate governance, including internal control. Since the focus of this thesis is on internal control, we will not give a detailed description of the entire code.\textsuperscript{52} Paragraph 3.7 Internal control and Internal Auditing and paragraph 5.2 Report on Internal Controls are the two paragraphs in the Swedish code that deal with internal control, see table 3 and 4 for the full text.

\begin{table}[h]
\begin{tabular}{|l|
\hline
3.7 Internal Control and Internal Auditing  \\
\hline
The board is responsible for the company’s internal control, which has the general aim of protecting the shareholders’ investment and the company’s assets.  \\
\hline
3.7.1  \\
The boards is to ensure that the company has a sound system of internal controls and keep itself informed of and assess how well it functions.  \\
\hline
3.7.2  \\
The board is to submit an annual report on how that part of internal control dealing with financial reporting is organised and how well it has functioned during the most recent financial year. The report is to be reviewed by the company’s auditors.  \\
\hline
3.7.3  \\
The board in companies that do not have a special internal audit function is annually to evaluate the need of such a function and explain the position that it has taken in its report on internal control.  \\
\hline
\end{tabular}
\end{table}

Table 3: Internal control in the Swedish Code of Corporate Governance, §3.7.
Source: Swedish Code of Corporate Governance, (Stockholm, 2005), §3.7, p. 31


\textsuperscript{52} For more information about the development of the Swedish Code of Corporate Governance and the objectives of the code, see Appendix 1.
5.2 Report on Internal Controls

5.2.1 The board’s report on internal controls and the auditors’ review of this report is to be appended to the company’s annual report in accordance with 3.7.2. This report may also be included in the printed annual report or constitute a separate report but it is not part of the formal financial statements.

Table 4: Internal control in the Swedish Code of Corporate Governance, §5.2. Source: Swedish Code of Corporate Governance, (Stockholm, 2005), p. 36

4.2. Compilation of the Swedish corporate governance code

The paragraphs in the Swedish code regarding internal control have been compiled based on the four key concepts described in the methodology: Definition, Objective, Responsibilities and Report. See table 5.

| Definition: | There is no definition of internal control in the Swedish code. |
| Objective: | The objective with an internal control system is according to the code protecting the shareholders’ investment and the company’s assets. |
| Responsibility: | The Board is responsible for the company’s internal control. It should ensure that the company has a sound system of internal controls and keep it self informed of and assess how well it functions. |
| Report: | The board is to submit an annual report on the part of internal control dealing with financial reporting. The report is to be reviewed by the company’s auditors. |

Table 5: Compilation of the Swedish Code of Corporate Governance, based on key concepts. Source: Swedish Code of Corporate Governance, (Stockholm, 2005), p 31-36.

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53 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 31
54 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 31
55 Swedish Code of Corporate Governance, (Stockholm, 2005), p.31, 36
4.3. Compilation of 13 European Union Member States Corporate Governance Codes

The same key concepts have been applied on the respective 13 corporate governance codes of European Union member states. For the results of these compilations see table 6-18.

**BELGIUM**

**Definition:** Systems to identify, assess, manage and monitor financial and other risks.56  
**Objective:** –  
**Responsibility:** The Board (the Audit Committee) is responsible for reviewing the existence and functioning of a system of internal control.57 Executive management should put internal controls in place.58  
**Report:** Statements on internal control shall be included in the annual report.59

Table 6: Compilation of the Belgian Code on Corporate Governance, based on key concepts.  

**CYPRUS**

**Definition:** –  
**Objective:** To safeguard shareholders’ investments and the company’s assets.60  
**Responsibility:** The Board of Directors should maintain a healthy system of internal control.61  
**Report:** Once a year a report on corporate governance, including the effectiveness of the internal control system (including financial, operational and compliance controls and risk management) should be presented to shareholders.62

Table 7: Compilation of the Cypriot Corporate Governance Code, based on key concepts.  

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56 The Belgian Code on Corporate Governance (2004), §6.5, p. 18  
57 The Belgian Code on Corporate Governance (2004), §1.3, p. 11  
58 The Belgian Code on Corporate Governance (2004), §6.5, p. 18  
59 The Belgian Code on Corporate Governance (2004), §5.2/7, p. 27  
60 Corporate Governance Code (2002), C.2., p. 15  
61 Corporate Governance Code (2002), C.2., p. 15  
62 Corporate Governance Code (2002), C.2.1, p. 15
CZECH REPUBLIC

Definition: –

Objective: To manage, rather than eliminate, the risk of failure to achieve business objectives.63

Responsibility: The Board is responsible for the group’s system of internal control and for reviewing its effectiveness.64

Report: A report covering all controls, including financial, operational and compliance controls and risk management shall be submitted to the shareholders.65

Table 8: Compilation of the Czech Corporate Governance Code, based on key concepts.

DENMARK

Definition: –

Objective: –

Responsibility: The Supervisory Board should review and assess the internal control systems within the company and the management’s guidelines for and monitoring of such systems.66

Report –

Table 9: Compilation of the Danish Report on Corporate Governance, based on key concepts.
Source: Report on Corporate Governance in Denmark (2003), p. 25

66 Report on Corporate Governance in Denmark (2003), p. 25
FINLAND

Definition: –

Objective: To ensure the effective and successful operation of the company, reliable information and compliance with relevant regulations and operating principles.67

Responsibility: The Company shall define the operating principles of internal control. The Board shall ensure that the company has defined the internal control procedures and monitor the effectiveness of such control.68 The Audit Committee shall evaluate the adequacy and appropriateness of internal control and risk management.69

Report: –

Table 10: Compilation of the Finnish Corporate Governance Recommendations, based on key concepts. Source: Corporate Governance Recommendations for Listed Companies (2003), p. 10-15

GREECE

Definition: –

Objective: –

Responsibility: Internal control is carried out by a special company service, staffed by at least one person.70 The internal controller is appointed by the Board of Directors but remains independent in the exercise of his duties.71

Report: –

Table 11: Compilation of the Greek Principles of Corporate Governance, based on key concepts. Source: Principles of Corporate Governance (2001)

67 Corporate Governance Recommendations for Listed Companies (2003), p. 15
68 Corporate Governance Recommendations for Listed Companies (2003), p. 15
69 Corporate Governance Recommendations for Listed Companies (2003), p. 10
70 Principles of Corporate Governance (2001), §4.1.
71 Principles of Corporate Governance (2001), §4.3.
**HUNGARY**

**Definition:** –

**Objective:** To guarantee the achievement by the company of the performance and financial targets. To ensure the efficiency of the company’s operations, the reliability of its financial reports, and that the company complies with to legal regulations in effect.72

**Responsibility:** The Board is responsible for that internal control mechanisms are in place.73 The Management is responsible for establishing and maintaining a system of internal control.74

**Report:** Once a year the company shall file a mandatory declaration that it fulfils the corporate governance recommendations including regulations regarding internal control.75

Table 12: Compilation of the Hungarian Corporate Governance Recommendations, based on key concepts.
Source: Corporate Governance Recommendations (2003), p. 8-22

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72 Corporate Governance Recommendations (2003), p. 22
73 Corporate Governance Recommendations (2003), p. 13
74 Corporate Governance Recommendations (2003), p. 22
75 Corporate Governance Recommendations (2003), p. 8-9
ITALY

Definition: The internal control system is the set of processes serving to monitor the efficiency of the company’s operations, the reliability of financial information, compliance with laws and regulations, and the safeguarding of the company’s assets.76

Objective: –

Responsibility: The Managing Directors shall identify the main risks the company is exposed to and submit them to the board of directors for its examination. They shall implement the guidelines laid down by the board of directors for the planning, operation and monitoring of the internal control system and shall appoint one or more persons to run it and provide them with appropriate resources.77 The Board of Directors is responsible for the internal control system; it shall lay down the guidelines for the system, periodically check that it is adequate and working properly.78

Report: –

Table 13: Compilation of the Italian Corporate Governance Code, based on key concepts.

MALTA

Definition: –

Objective: To maintain a high level of decision-making capability and accuracy of its reporting and financial result and to protect the interests of the company’s shareholders.79

Responsibility: The Board should regularly review processes and procedures to ensure the effectiveness of its internal systems of control.80

Report: –

Table 14: Compilation of the Maltese Report on Corporate Governance, based on key concepts.

76 Corporate Governance Code (2002), §9.1, p. 13
SLOVAKIA

Definition: –

Objective: To safeguard shareholders' investment and the company's assets.\(^{81}\)

Responsibility: The Executive Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.\(^{82}\) The Supervisory Board should review the effectiveness of the company's system of internal control.\(^{83}\)

Report: The members of the supervisory board shall report to shareholders. This report should cover all controls, including financial, operational and compliance controls and risk management.\(^{84}\)

Table 15: Compilation of the Slovakian Corporate Governance Code, based on key concepts.

SLOVENIA

Definition: –

Objective: To protect the shareholders’ interests and the company’s assets.\(^{85}\)

Responsibility: The Management Board shall provide for establishment and operation of a proper and effective system of internal control.\(^{86}\) The Supervisory Board may appoint an Audit Committee. Its duties are among others: supervision of risk control, internal audit and the system of internal control.\(^{87}\)

Report: –

Table 16: Compilation of the Slovenian Corporate Governance Code, based on key concepts.
Source: Corporate Governance Code (2004), p. 11-15

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\(^{81}\) Corporate Governance Code – Based on the OECD Principles (2002), §1.2, p. 14
\(^{82}\) Corporate Governance Code – Based on the OECD Principles (2002), §1.2, p. 14
\(^{83}\) Corporate Governance Code – Based on the OECD Principles (2002), §5.9, p. 30
\(^{84}\) Corporate Governance Code – Based on the OECD Principles (2002), §5.9, p. 30
\(^{85}\) Corporate Governance Code (2004), §6.2.1, p. 15
\(^{86}\) Corporate Governance Code (2004), §6.2.1, p. 15
\(^{87}\) Corporate Governance Code (2004), §3.7.1, p. 11
THE NETHERLANDS

Definition:  –
Objective:  –
Responsibility:  The Management Board should indicate in the declaration on the internal risk management and control systems what framework or system of standards (for example the COSO framework for internal control) it has used in evaluating the internal risk management and control system.88

Report:  A Declaration on the internal risk management and control systems should be published together with the annual report.89

Table 17: Compilation of the Dutch Corporate Governance Code, based on key concepts.
Source: The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions (2003), p. 34

UNITED KINGDOM

Definition:  –
Objective:  To safeguard shareholders’ investment and the company’s assets.90
Responsibility:  The Board should maintain a sound system of internal control.91
Report:  The board should, at least annually, conduct a review covering all material controls, including financial, operational and compliance controls and risk management systems and report to shareholders that they have done so.92

Table 18: Compilation of the British Code on Corporate Governance, based on key concepts.
Source: The Combined Code on Corporate Governance (2003), p. 15

88 The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions (2003), §II.1.4, p. 34
89 The Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions (2003), §II.1.4, p. 34
90 The Combined Code on Corporate Governance (2003), §C.2, p. 15
91 The Combined Code on Corporate Governance (2003), §C.2, p. 15
92 The Combined Code on Corporate Governance (2003), §C.2.1, p. 15
4.4. Compilation Summary

The compilations of the corporate governance codes are summarized in the following country/key concept matrix:

<table>
<thead>
<tr>
<th>Country</th>
<th>Definition</th>
<th>Objective</th>
<th>Responsibility</th>
<th>Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
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<tr>
<td>Belgium</td>
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<tr>
<td>Cyprus</td>
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<tr>
<td>Czech Republic</td>
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<td>Denmark</td>
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<td>Finland</td>
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<td>Greece</td>
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<td>Hungary</td>
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<tr>
<td>Italy</td>
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<td>Malta</td>
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<td>Slovenia</td>
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<td>The Netherlands</td>
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<tr>
<td>The UK</td>
<td>X</td>
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</tbody>
</table>

Table 19: Summary of the occurrence of the key concepts in corporate governance codes. Source: Authors’ own compilation.
5. Analysis
In this chapter we will present our analysis of the empirically compiled corporate governance codes. First we will shortly present the structural differences between the codes and thereafter we will present our analysis for each key concept. Within each key concept we start by presenting the appearance of the concept the Swedish code, then the similarities and discrepancies we found when comparing this code to the others. After this we will draw parallels between the concepts in the codes and the COSO framework. At the end of the analysis of each concept we will present our thoughts on what impact these differences might have, if, or when, harmonizing these internal control regulations.

5.1. Structure
The most obvious structural difference between the countries is the fact that a few of them do not have a code at all. Another evident difference is that several of the codes do not mention internal control. The codes containing internal control regulations have different ways of presenting them. The Swedish code has two separate sections; 3.7 Internal Control and Auditing and 5.2 Report on Internal Controls, dealing exclusively with this issue. In many other codes internal control is mentioned for instance when stating the responsibilities of the board or the management. Few countries have all information concerning internal control gathered in secluded paragraphs like Sweden.

5.2. Definition
The Swedish code has, as mentioned earlier, been criticized for its lack of definition of internal control, but as we can see from the study, Sweden is not the only country short of a definition. Only two out of the 14 corporate governance codes (the codes that mention internal control, including the Swedish code) have a definition of internal control. The Belgian Code on Corporate Governance declares that: “Executive management should put internal controls in place (i.e. systems to identify, assess, manage and monitor financial and other risks)...”93. The Corporate Governance Code of Italy has adopted the definition of internal control from the COSO report; “The internal control system is the set of processes serving to monitor the efficiency of the

93 The Belgian Code on Corporate Governance, (2004), p. 18
company’s operations, the reliability of financial information, compliance with laws and regulations, and the safeguarding of the company’s assets”.

We are surprised that not more codes refer to the COSO framework, but perhaps the COSO framework is not as dominating as our sources imply. The only codes, in which we could find references to the COSO framework, were the Dutch and the Italian codes. The Dutch corporate governance code says “It would be logical for the management board to indicate in the declaration on the internal risk management and control systems what framework or system of standards (for example the COSO framework for internal control) it has used in evaluating the internal risk management and control system.” And as mentioned above, Italy has explicitly adopted the definition of internal control from the COSO report.

We also find it odd that not more codes have a definition of internal control, considering that a clear definition ought to be essential for complete understanding of the internal control regulations, and a lack of definition could create room for individual company interpretations of the regulations. However, this could be a deliberate strategy from authorities to allow room for changes in best practice, and thus avoiding having to re-write the code frequently.

The fact that so many codes do not have a definition of internal control, could be a facilitating factor if harmonizing the codes, providing that the countries that do not define internal control in their corporate governance code, all interpret it in the same way. On the other hand, if every country has its own unique view of what internal control is, there would be an obvious problem when harmonizing. The lack of definitions of internal control in the codes could also, if internal control is interpreted in diverse ways in the different countries, mean that our analysis and conclusions regarding the other key concepts are less accurate, since they are all related.

5.3. Objective

The Swedish code describes the objective of internal control as to protect shareholders’ investment and the company’s assets. This objective focuses mainly on the monetary resources of

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the company. Similar objectives are described in the codes of Cyprus, Slovakia, Slovenia and United Kingdom.

An additional four codes express the purpose of internal control: Malta, Hungary, Finland and the Czech Republic. In the Maltese code the focus, as in the Swedish code, is on protecting the shareholders’ interests, but in the Maltese Code it is expressed in a more general sense. It also expresses the objective of internal control as to maintain a high level of decision-making capability and accuracy of its reporting and financial result.

Hungary and Finland describes the objectives of internal control as follows:
- to ensure efficiency and effectiveness of the company’s operations
- to ensure reliability of information (in Hungary; financial reports)
- to ensure compliance with relevant regulations and principles

However, there is a slight difference between the perspectives of the objective of these two codes. Hungary, as opposed to Finland, express more explicitly that these objectives shall be fulfilled in the best interest of the shareholders.

The corporate governance code of the Czech Republic differs from the Swedish, as well as from the others, due to its comprehensibility. It simply states that the purpose of internal control is to manage the risk of failure to achieve business objectives.

None of these eight codes containing objectives also contains a definition. The reason for this could be that the two concepts might not always be easy to distinguish between. Many of the objectives above are similar to the categories in the internal control definition in the COSO report; effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations and safeguarding of assets. None of the codes contain all four of these categories in their description of the objective of internal control. Differences in objectives create harmonization issues quite similar to the ones discussed in the paragraph 5.2 Definition above, due to the close relation between definition and objectives of internal control.
5.4. Responsibilities

The responsibility concept is present in all the codes analysed, yet in different ways. According to the Swedish code of corporate governance, the Board is responsible for the company’s internal control. Its tasks are to ensure that the company has a sound system of internal control and keep itself informed of and assess how well it functions. Any other responsibilities regarding internal control are not mentioned in the text. Five other countries; the Czech Republic, Cyprus, Denmark, Malta and the United Kingdom, like Sweden, emphasize the board solely as responsible for the internal control. When it comes to what these boards are responsible to do, they differ somewhat in their formulations, for example maintain, review and assess the system of internal control. The authorities of the above countries, might state the Board as solely responsible for internal control, since they see the Board as capable of delegating the other responsibilities within their organizations.

The countries that, unlike Sweden, divide the responsibility between the board and management are Belgium, Hungary, Italy, Slovakia and Slovenia. The responsibilities of Management are described as for example putting the internal controls in place or establishing and maintaining the internal control system. The Boards on the other hand, have similar responsibilities as described in the paragraph above, that is, a more general responsibility.

Three countries differ from Sweden as well as the rest: Finland, Greece and the Netherlands. Finland states the Company in general to be responsible for defining the operating principles of internal control. The Board is then responsible for ensuring that the company has defined these principles as well as monitoring their effectiveness. It is also responsible for evaluating the adequacy and appropriateness of the internal control. The corporate governance code of Greece is the most deviant one regarding their distribution of responsibility. From the Greek point of view “Internal control is carried out by a special company service, staffed by at least one person”96 – the internal controller, who is appointed by the board of directors and shall remain independent in the exercise of his duties. The code does not define what these duties are.

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96 Principles of Corporate Governance, Greece, (2001), section 4.1
The Dutch code states that the management board should evaluate the internal risk management and control systems and indicate what system of standards it has used when doing this (for example the COSO framework).

According to the COSO report everyone in the organization has a responsibility for the internal control. As seen above, many countries divide the responsibility between the board and the management, but none mention the responsibility of the staff in general. In the cases where the responsibility is divided between management and board this is usually done in the same fashion as in the COSO framework.

Differences in responsibilities could be one of the most complex issues to consider when harmonizing. Responsibilities could be regulated in national laws and restructuring the responsibilities in an attempt to harmonize could collide with these laws. Yet, the differences in the codes analysed, regarding responsibilities, seem to be minor, especially if the codes that state the Board as solely responsible, really expect the Board to delegate the responsibilities according to the COSO framework. These insignificant differences would therefore, in our opinion, not cause any major problems.

5.5. Report

The Swedish code states that "The board is to submit an annual report on how that part of internal control dealing with financial reporting is organised..."97. Reporting on any other parts of internal control is not mentioned, as in for instance the British, or the Cypriot code: “Directors should, at least once a year, conduct a review of the effectiveness of the group’s system of internal control […] This inspection should cover all systems of internal control, including financial, operational, as well as compliance controls and risk management.”98 The Czech Republic and Slovakia has almost identical formulations as Cyprus regarding reports on all the parts of internal control, but as opposed to Cyprus and Sweden they do not demand that this report is conducted annually. The other countries demanding reporting on an annually basis are Belgium, Hungary, the Netherlands and the United Kingdom.

97 Swedish Code of Corporate Governance, (Stockholm, 2005), §3.7, p. 31
98 Corporate Governance Code (2002), C.2.1, p. 15
Belgium is very concise in its description of the reporting of internal control when only demanding that statements on internal control should be included in the annual report. United Kingdom has an ambiguous formulation regarding the report, saying that the Board should conduct a review of internal controls and then report to the shareholders *that they have done so*. Thus, there is no mentioning that they have to report on *the results* of the review.

Whether companies shall report on their internal control systems or not, is beyond the scope of the COSO report. It is however understandable that a standardized reporting system would be of great interest for, for example, investors, seeking to compare the internal control and corporate governance systems, in different companies. Based on the many similarities between the reports, presented above, it does not seem too difficult to harmonize the internal control reporting standards. Nevertheless, even if the report itself would not cause problems, the work that precedes the presentation of the reports could do so, based on the demanded extent of the report.
6. Conclusions

The corporate governance codes analysed in this thesis originates from European nations with different cultures, financing traditions and ownership structures. Given their different origins, the codes are remarkably similar, especially in the attitudes they express about responsibilities. One possible reason for these similarities could be their time of establishment; they are all published between 2001 and 2004. The fact that the countries are part of the European Union could be yet another reason for the similarities.

It is difficult to know how the countries that do not have a corporate governance code, view internal control. It is even more difficult for us to try and assess what impact these countries would have on a harmonization process. On the other hand, the corporate governance codes might not be the only recommendations regarding internal control. We have no knowledge whether there are legal rules and restrictions that also influence the internal control systems in the analysed countries. If that is the case, those differences could definitely have a decisive influence on the internal control part of a possible common EU corporate governance code.

It is beyond our knowledge whether there really is a need for harmonization of the internal control regulations and corporate governance codes in the European Union member countries. Still, given the current process of harmonization in this area, it is not unlikely that a uniform European corporate governance code, including regulations regarding internal control, might become a pressing issue in the near future. A harmonization creates a need for understanding the commonalities and differences between national practices.

As described in the analysis, we could find that there are variations, for the most part small, between the countries, within each complex key concept. These differences may of course be of great importance to individual companies acting in foreign markets, or expatriates working in management level or higher in international organizations. However, looking at the bigger picture with harmonization on an international level, imagining a design of a common EU corporate governance code, we believe these differences to be insignificant, since the internal control sections in the codes generally differ more in form than in substance. When speculating about the establishment of a uniform EU corporate governance code, it would also be important to consider
what influence the American Sarbanes-Oxley Act might have on such a constellation. Another matter is what conclusions could be made from the fact that so many codes do not define internal control. If there is no definition of internal control in the different codes – is it possible to assess whether they are designated to the same objectives?

6.1. Ideas for Related Studies

It would be interesting to perform a study comparing the internal control aspect in the American Sarbanes-Oxley Act with the same aspect in codes published by the European Union member states. Another interesting study would be to investigate if “Internal control” means different things in different European countries. In this thesis we have assumed all countries to mean the same thing, but if presuming the countries have different interpretations of internal control; that will create a whole new question at issue.
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Appendix

Appendix 1: The Swedish Code of Corporate Governance (SOU 2004:130)

“The initial work developing the Code was conducted by a special working group called the Code Group as a joint effort of the Commission on Business Confidence (Förtroendekommissionen) and the following bodies and organisations in the business community: FAR (the institute for the accountancy profession in Sweden), the Swedish Investment Fund Association, the Swedish Industry and Commerce Stock Exchange Committee (NBK), the Stockholm Stock Exchange, the Stockholm Chamber of Commerce, the Swedish Bankers’ Association, the Swedish Securities Dealers Association, the Confederation of Swedish Enterprise, the Swedish Shareholders’ Association and the Swedish Insurance Federation.”

A proposal, Swedish Code of Corporate Governance (SOU 2004:46) was submitted by the Code Group, on April 21, 2004. The proposal was circulated for comments, to 97 bodies for consideration and public debate. On September 30, 2004 the Government appointed a committee instructed to review the comments received in response to circulation of the report and to draw up a revised code. The Government instructed the committee to finish its report no later than December 17, 2004. Erik Åsbrink, former Minister of Finance, was appointed chairman of the committee.

On December 16, 2004 the committee presented its report, the Swedish Code of Corporate Governance (SOU 2004:130). “The code is based on the Swedish Companies Act (Aktiebolagslagen, 1975:1385) and the tradition of self-regulation ...” The code is also founded on the principle “comply or explain” – which means that “a company following the Code may depart from individual rules; however, in that event, it must provide an explanation stating the reasons for each departure reported.” The general aim of the code is to “help improve corporate governance in Swedish companies.” The code is directed primarily at stock market companies, but the good corporate governance in these companies is expected to influence and serve as a model for other types of companies.

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100 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 4
103 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 3
104 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 10
105 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 8
106 Swedish Code of Corporate Governance, (Stockholm, 2005), p. 8