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IL SISTEMA DUALISTICO IN GERMANIA E ITALIA

"THE ROLE OF THE AUDITOR AND THE AUDIT COMMITTEE IN THE DUALISTIC SYSTEM"

The role of the external auditor:

In order to explain the role of the external auditor in the two-tier system of governance, it's important to start by saying that, similarly to the other two board models (the traditional system and the one-tier system), the Civil Code provides for the separation of the administrative control from the accounting control (art. 2409-quinquiesdecies as recalled by 2409-bis c.c.).
All corporations that decide to adopt the dualistic system will operate under the control of an external auditor, whose duties in the case of listed corporations are performed by an auditing firm.
In fact, in the two tier system the bylaws can not internalize the functions of the external auditor, differently from the traditional system where, if certain conditions are satisfied, the bylaws can devolve the functions performed by the external auditor to the statutory board of auditors (collegio sindacale).

The devolution of the control over financial statements to an external auditors is functional to the scope of reducing the asymmetric information that arrise between management and shareholders and, thus, lowering the cost of capital.
The scope can be pursued if the external auditor adeguatly performs its gate-keeping role.
Gate-keepers can be defined as "reputational intermediaries who provide verification and certification services" (*Coffee Jr.*).
These services can assume different vests, like evaluating the credit worthiness of a company, assesing the company's business and financial

prospects via a vis its rivals and, as in the case of external auditors, verifying the company's financial statements.
The reason why auditors' verifications and certifications are evaluated by the market as credible and reliable, therefore becoming a mean of reduction of asymmetric information, is easily said.
Being reputational intermediaries, they receive a far smaller benefit than do their clients from the operations they certify: in the case of a fraud, they share none of the gains (or just a small fraction of it) and are exposed to the risk of losing the reputational capital built up over many years, in addition to legal liability.
Accordingly, gate-keepers can credibly offer a collective service to investors and creditors even thought they are paid by companies.

It then becomes clear that the crucial point of the all gate-keeping theory lies in the independence of the external auditor.
With this regard, the Italian law assures the independence, stating several rules (artt. 2409-*quarter*; 2409-*quinquies* c.c. and artt. 159-163 T.U.F. – the Italian Consolidated Financial Services Act). Very briefly, the external auditor is nominated by the shareholder's meeting, which also determine its compensation, following the express opinion of the corporate body to which control functions are assigned. Also, in the case of listed companies, the appointed auditor can be prevented from taking up its task, if the Consob (the independent authority responsible for regulating the Italian securities market) belives that the auditor is not technically fit to perform its duty.
The removal can be obtain only with another deliberation of the shareholder's meeting, with the prior opinion of body to which control functions are assigned and the ratification of the competent court or the Consob (if the company is listed).
Auditors and auditing companies must have as their exclusive activity the financial auditing and the law also states several ineligibiliy and incompatibility requirements among which, for listed companies, the prohibition of providing non-audit services to the firm they are auditing. Finally a mandatory rotation is also prescribed, imposing that after two tenures, the auditor is subject to a cooling period of three years before being able to furnish the financial audit activity for the same company again.

The gate-keeping theory also declines itself in the specific task that the external auditor is called to perform under Italian law (art. 2409-*ter* and artt. 155, 156 T.U.F.). More specifically his duties consist in:

- verify the regulararity of financial reporting and the correspondence between financial data and management operations;

- verify that the balance sheet is prepared in conformity with the generally accepted accounting principles and the other legal requirements;

- express an opinion about the financial statements.

In other words, the accounting control consists in the acquisition of all the information necessary to verify, with reasonable certainty, the adherence of the contents of the balance sheet to the accounting procedures and the correspondence with the legal criteria.
Therefore the financial auditing performed is functional to allow the external auditor to express a comprehensive judgement on whether and how the firms has complied with the accounting rules in drawing up the balance sheet.
In performing the financial auditing, the external auditor relies heavily on the system of internal control and on his capability of "smoking out" internal mistakes regarding the accuracy and reliability of financial data.
In fact, if an accounting function appeared to be under an adequate internal control, the auditor's investigative role could be limited to test of whether or not the control was functioning as intended.
That is not the only duty that can be assigned to the system of internal control, as we will see now inquiring into the role of the audit committee.

The role of the audit committee:

In order to try and explain the role of the audit committee in the contest of the Italian two tier system, it's necessary to first and briefly clarify the main object of the activity the audit committee is related with: the internal control.

Over the years, the international debate on the subject has been influenced by several reports, guidances, corporate governance codes, recommendations, rules (can be recalled, as the most important: COSO Report I, COSO Report II, the Turnbull Guidance, the Rule 404 of the Sarbanes-Oxley Act, the Recommendation of the European Commission 2005/162 dated 15-02-2005).

Drawing from them, the following definition is widely accepted:

Internal control can be defined as a process designed to provide reasonable assurance regarding the achievement of corporate objectives in three different areas:

- effectiveness and efficiency of operations;

- reliability of financial reporting;

- compliance with applicable laws and regulations.

Internal control over each of these objectives consists of five interrelated components:

- the control environment;

- risk assessment;

- control activities;

- information and communication;

- monitoring.

A system of internal control is deemed to be effective only if all five components are functioning effectively.

Through the creation of an audit committee made by its members, as it will be explained later on, the board is usually thought to strengthen its monitoring functions in two main directions:

- constrain managerial opportunism in seizing short-term profit opportunities that involve violations of corporate policies or legal rules;

- use the information flows associated with such control, to deal with the problem of asymmetric information that arise between the executives and the board;

Evidence shows that firms with strong internal controls experience a lower level of information risk which implies a lower cost of equity capital.

This being the international framework, the Italian regulation (the first traces of which can be found in the regulation promulgated in 1996 by the Bank of Italy) finds now a clear standpoint in the latest version (2006) of the Italian Corporate Governance Code.

The Italian Corporate Governance Code provides for the creation of an internal control committee made up of non-executive directors, the majority of which are independent. Also, keeping in mind the peculiar features of control structures in Italy (which are often caracteriezed by contentrated ownership in the vest of controlling minority structures), it also states that, if the issuer is controlled by another listed company, the internal control committee shall be made up exclusively of independent directors. At least one of the member of the committee must have an adequate experience in accounting and finance, to be evaluated by the Board of Directors at the time of his/her appointment.

The committee has advisory and consulting powers in order to ensure that the Board of Directors is supported by an adequate preliminary activity before evaluating and taking the decision relating to:

- the internal control system;

- the approval of the balance sheet and the half yearly reports;

- the relationship between the issuer and the external auditor.

In addition to this "assignment", the committee can be called to play a role when a related party transaction takes place.
In first instance, the Corporate Governance Code provides that the Board shall, after consulting with the internal control committee, establish approval and implementation procedures for the transactions caried out by the issuer, or its subsidiaries with related party.
In practice, several criteria have been identified. One of them involves the presence of the internal control committee which may be called to give a prior opinion on the operation.

These general considerations on the role of the internal control committee can be easily adapted to the two-tier system of corporate governance in its "classical" versions: a management board made up by a small number of directors, all of them executive, and a larger supervisory board with monitoring functions (that can be pushed as far as requiring its approval for spefic types of transactions).
In this case, the audit committee is likely to be nominated inside the supervisory board, as indeed advised in the artt. 5 and 7.2. of the European Commission Recommendation 2005/162/CEE, for the following specific reasons:

- a structural reason: the Code of Corporate Governance, as we have seen before, provides for the creation of an audit committee made up of non-executive directors, a majority of which independent;

- two functional reason (*Eisenberg*):

- the supervisory board, in addition to the power of designation, removal and determination of the compensation, performs a peculiar kind of monitoring function over the executives, which involves the merits of the administration.
  Accordingly, in order to exercise both its monitoring and decision functions, the board needs reliable informations. That is not always possible because a serious problem of asymmetric information arises between the executives, who are being monitored and are proposing decision, and the supervisory board, which is monitoring the executives and approving, in the case, these decisions. The executives, normally have at their disposal all information that relates to their own performance and to the decisions they propose. Because evaluations and decisions are shaped by the information avaiable to the decisionmaker, if the executives control the information the board receives, the board monitoring and decisionmaking functions often will be little more than nominal.

- the second reason for vesting ultimate responsibility for an internal control structure in the board concerns managerial opportunism. Managers often have short term tenures and they are usually under great pressure to produce short term-results, also keeping in mind that compensation may also be linked to those results. Accordingly, it is often in a manager's interest to opportunistically maximize reported profits during his tenure, even if doing so involves taking actions of a kind that are either prohibited by corporate policies or by law. (Furthermore, the anticipated profit to be made on a transaction that would violate corporate policy or a legal rule is typically large, present, vivid. In contrast, from a manger's perspective the possible loss from violating a corporate policy or legal rule will often seem insignificant, pallid and very remote especially when discounted for the probability of detention).

The picture just drawn, is not the only one available.
Under Italian law, it's possible for the management board to delegate its functions to one or more of his members thus passing from a two-tier system of governance to, what could be called, a three-tier system of governance.
In the case, the question becomes in which corporate body should be placed the audit committee.

From a normative point of view, the Code of Corporate Governance does not force the company to constitute the internal control committee inside a specific corporate body: therefore the committee may be placed either in the management board (that, in this case, will be made up of both executive and non-executive directors) or in the supervisory board.

It needs also to be said that, in the practice where a three-tier system of governance has been set up, a preference towards a collocation of the internal control committee inside the supervisory board can be found.

In conclusion, what can be said on the subject is that all the doubts raised by the legal doctrine and by the economic literature upon the efficiency and the functionality of a governance model, where a duplication of the monitoring functions takes places, finds in the issue concerning the collocation of the audit committee, a new, subordinated argument.

The question concerns, more precisely, the monitoring function of which corporate body is preferable, or more efficient, for the audit committee to improve and consequently the role of the supervisory board.

The subject is very complicated and just a few brief consideration can be made.

In particular, if the supervisory board is thought to exercise a function which is closer to the one performed by the statutory auditors in the traditional system, it might be more easy to justify a three-tier board and the collocation of the audit committee in the management board (which, in the case, will be also made up of non-executives directors).

Otherwise, if the supervisory board is thought to exercise a monitoring activity functionally similar to the one performed, for example, by the board over the directors in the American model of governance, then the assignment of similar functions to two different corporate bodies is hard to explain.

And if such a duplication is hard to explain, it then follows that the collocation of the audit committee becomes an open issue that, most likely, only a careful exam of the future practice will answer.