Chapter 14

Control and Audit Procedures

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The Chairman's Checklist

- ✓ What is the relationship between the Revision Commission, Supervisory Board's Audit Committee, Internal Auditor, and/or Control and Revision Service? Have their roles and responsibilities been properly defined to avoid overlap and conflict?

The Revision Commission:

- ✓ Is the Revision Commission fulfilling its function and duties? Has the Revision Commission ever found, and reported on, possible misstatements or other violations to the General Meeting of Shareholders?
- ✓ Who are the members of the Revision Commission? Are any employees members? Are the members fully independent from management?
- ✓ Does the Revision Commission meet regularly and respond to all shareholder requests and inquiries?

The External Audit:

- ✓ Does the company have an independent External Auditor? Does the External Auditor provide other, non-audit services to the company that could compromise his independence? Are audit partners rotated?
- ✓ How is the External Auditor selected? Does an open tender process take place? If so, who organizes this tender process?
- ✓ To whom does the External Auditor report?
- ✓ Does the External Auditor participate in the Annual General Meeting of Shareholders and answer all questions posed by shareholders?

The Audit Committee:

- ✓ Should the company's Supervisory Board have an Audit Committee? What are the costs and benefits?
- ✓ If the company has an Audit Committee, is it staffed with individuals who are independent, able, and willing to do the job properly and effectively?
- ✓ Does the Chairman of the Audit Committee have the requisite professional and human relations skills? Are Audit Committee members publicly recognized financial experts?
- ✓ Does the Audit Committee meet often enough to perform its duties effectively? Does it place the necessary and appropriate issues on the agenda?

- ✓ Does the Audit Committee add value to the Supervisory Board's discussion of audit, risk, internal control, and financial reporting?
- ✓ Does the Audit Committee receive the necessary information to perform its duties effectively? Does it have resources to hire outside accounting or legal advice?
- ✓ Does the Audit Committee perform self-evaluations on a regular basis?

Internal Control:

- ✓ Does the company have a system of internal control in place? Does the company have a formal document that regulates the internal control system and procedures? Is this document periodically reviewed?
- ✓ Does the company have a risk management system in place? Does this system cover risk at the subsidiary level as well? How are business, operational, and financial risks identified?
- ✓ Does the Internal Auditor report to management or the Supervisory Board? To whom should the Internal Auditor report? Are there barriers that could discourage the Internal Auditor from reporting problems to the company?

A system for internal and external audit is an important tool both in the management and oversight of a company, and also contributes to transparent and sound financial reporting. There are a number of internal structures and external agents involved in the management and oversight of company finances and operations. These bodies are diverse in their nature, functions, and reporting lines. Some are mandatory, while others are optional.

The *Revision Commission* focuses on controlling financial and business activities of the company and monitoring compliance with laws and regulations. The mission, scope, and duties of the Revision Commission are narrower than that of the Audit Committee. The Revision Commission may: monitor compliance with regulations governing the company's business operations; express an opinion on whether reports and financial statements provide a true and accurate picture; and ascertain whether business and financial transactions are recorded properly. The Revision Commission reports to shareholders.

The *independent External Auditor* examines a company's financial and accounting records, as well as supporting documents, in all material respects. Shareholders depend upon the External Auditor to express an independent opinion that the financial statements of an enterprise are reliable.

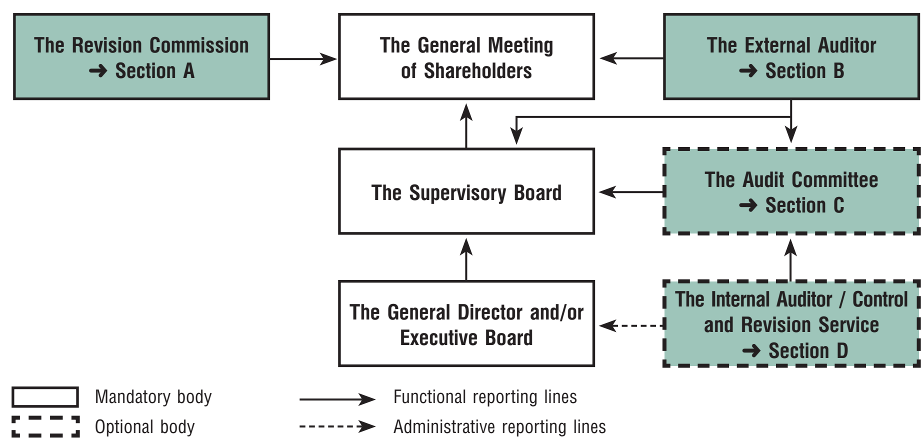
The *Supervisory Board's Audit Committee* safeguards the company by questioning executive bodies regarding the way in which financial reporting responsibilities are handled, as well as by ensuring that corrective actions are being taken. The Audit Committee oversees the Internal Auditor and the company's relations with the External Auditor. It may consider the appointment of an External Auditor, review the internal audit plan, review the effectiveness of internal control systems, consider major findings of internal audit investigations and management responses to these, and promote co-ordination between the Internal and External Auditors. Finally, the Audit Committee may consider the draft annual accounts and review the External Auditor's conclusions on annual financial statements. The Audit Committee is part of the Supervisory Board, and as such, develops recommendations for the Board's consideration; the Audit Committee consequently has no independent decision-making authority.

The *Internal Auditor* (or *the Control and Revision Service*) is responsible for the ongoing daily appraisal of the financial health of a company's operations. Company employees carry out this function. During an internal audit, Internal Auditors evaluate and monitor a company's risk management, reporting, and control practices, and make suggestions for improvement. Internal auditing not only covers the finance function, but also the company's operations and systems. The Internal Auditor reports to the Supervisory Board, ideally to its Audit Committee, on a functional basis, and to the General Director on an administrative basis.

> **Best Practices:** Audit committees have only recently been introduced in Russia, where there is more experience with Revision Commissions. Questions may arise over the extent to which the responsibilities of these two bodies overlap, and which is best able to oversee the preparation of financial information and assess the systems of internal controls. At present, it appears that given the differences in their mandate, they could fulfill complementary functions. However, many experts will argue that the function of the Revision Commision does indeed overlap with the External Auditor and the Audit Committee; most countries throughout the world have chosen to strengthen the latter two, and many have chosen to abolish the Revision Commission.

This chapter discusses the role, authority, and duties of these various bodies in detail, and how they specifically contribute to company transparency and information disclosure. For an overview of these agents and their reporting lines, see Figure 1.

Figure 1: Management Structures and External Agents According to Law and Best Practice



Source: IFC, March 2004

A. The Revision Commission

The Revision Commission controls the operations and financial activities of the company.[120] Any company, regardless of its legal form (open or closed), must have a Revision Commission. Its primary function is to provide an independent opinion on the reliability of the company's financial information to the company's shareholders, as well as the company's compliance with laws and regulations during business operations.

1. The Composition and Requirements for Members

Revision Commissions may take a number of forms. They may be composed of a single individual or a number of individuals.[121]

> **Best Practices:** Because Company Law does not determine the number of Revision Commission members, companies should specify the number in the charter.

[120] Law on Joint Stock Companies (LJSC), Article 85, Clause 1, Paragraph 1.

[121] When this Manual makes reference to the Revision Commission, this also includes any individual who is performing the function of a Revision Commission.

Revision Commission members should be independent of the company's management, and may not be:[122]

- A Supervisory Board member;
- The General Director;
- An Executive Board member; or
- A Counting Commission member.[123]

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.[124]

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.[125] The charter and by-laws can provide additional requirements for Revision Commission members such as proficiency in accounting and financial reporting.[126]

2. 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);[127]
- Undertake extraordinary inspections of the company's finances and operations;[128]
- Review the accuracy of the company's annual report and annual financial statements;[129]

[122] LJSC, Article 85, Clause 6, Paragraph 1.
[123] LJSC, Article 56, Clause 2.
[124] FCSM Code, Chapter 8, Section 1.3.4.
[125] FCSM Code, Chapter 8, Section 1.3.3.
[126] FCSM Code, Chapter 8, Section 1.3.2.
[127] LJSC, Article 85, Clause 3.
[128] LJSC, Article 85, Clause 3.
[129] LJSC, Article 88, Clause 3, Paragraph 1.

- Demand an Extraordinary General Meeting of Shareholders (EGM);[130]
- Demand a Supervisory Board meeting to discuss items under its authority;[131]
- Request and receive minutes of Executive Board meetings;[132]
- Request and receive documents regarding the company's finances and operations from the executive bodies;[133] and
- Request and receive information concerning related parties and related party transactions.[134]

In addition, shareholders are provided with great flexibility in defining additional authorities of the Revision Commission in the charter.[135]

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.

3. The Nomination of Members

The procedure for nominating candidates to the Revision Commission is identical to the procedure for nominating candidates to the Supervisory Board, the

130 LJSC, Article 55, Clause 1, Paragraph 1; LJSC, Article 85, Clause 5.

131 LJSC, Article 68, Clause 1.

132 LJSC, Article 70, Clause 2, Paragraph 2.

133 LJSC, Article 85, Clause 4.

134 LJSC, Article 82.

135 LJSC, Article 85, Clause 2, Paragraph 1.

Executive Board, the Counting Commission, and for nominating the General Director.[136]

➜ *For more information on the nomination process, see Part III, Chapter 8, Section B.1.*

The charter can require that additional information about candidates be included in the proposal for their nomination.

4. The Election and Dismissal of Members

The agenda of the AGM must include the election of the Revision Commission.[137] This means that Revision Commission members are elected for a one year term and serve until the next AGM. The GMS cannot elect the Revision Commission by written consent.[138]

Revision Commission members are elected by a simple majority vote of participating shareholders.[139] It is important to note that Supervisory Board members, the General Director, and Executive Board members are not entitled to vote on the election of the Revision Commission.[140]

The authority of individual members of the Revision Commission can be terminated at any time by a simple majority vote of participating shareholders.[141]

Best Practices: Although the Company Law does not prohibit Supervisory Board members, the General Director, or Executive Board members from voting on the early termination of the Revision Commission, such a prohibition would be consistent with the prohibition on their election in the first place. Accordingly, it is good practice for company officials not to vote in such cases.

[136] LJSC, Article 53.

[137] LJSC, Article 47, Clause 1, Paragraph 3; Letter from the FCSM No. IK-07/883, 28 February 2000.

[138] LJSC, Article 50, Clause 2.

[139] LJSC, Article 49, Clause 2, Paragraph 1.

[140] LJSC, Article 85, Clause 6, Paragraph 2.

[141] LJSC, Article 48, Clause 1, Section 9; Article 49, Clause 2, Paragraph 1.

5. Contracts with Members

Companies may conclude an employment contract[142] or a civil law contract[143] with Revision Commission members.

Best Practices: Employment contracts are typically entered into with company employees who report directly to management. A company should thus conclude civil law contracts with Revision Commission members, underlining their independence from management.

The charter or by-laws should specify who signs the contract on behalf of the company. In principle, the Chairman of the General Meeting of Shareholders (GMS) or the Supervisory Board (who are often one and the same person) should do this. If, on the other hand, the General Director or another executive signs the contract, this would likely affect the independence of the Revision Commission, either in appearance or in fact. Of course, the authority to sign the contract does not imply the authority to negotiate or alter contract terms. Key elements and terms of the contract, for example, remuneration, are subject to the GMS' approval.

6. The Remuneration of Members

The GMS decides whether Revision Commission members are compensated for their work and reimbursed for expenses.[144] The Supervisory Board, ideally through a Remuneration Committee, if established, should recommend the amount of remuneration for GMS approval. A shareholder (or a group of shareholders) owning at least 2% of voting shares has the right to propose such agenda item.[145]

7. Operating Procedures

A Revision Commission's operating procedures can be specified in the charter or, preferably, in the company's by-laws for the Revision Commission, approved by

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[142] Labor Code, Article 59.

[143] Civil Code (CC), Articles 779–783.

[144] LJSC, Article 85, Clause 1, Paragraph 2.

[145] LJSC, Article 53, Clause 1.

the GMS.[146] Revision Commission members usually elect their Chairman during their first meeting. The charter or by-laws may provide the Chairman of the Revision Commission with the responsibility to:

- Call, organize, and preside over Revision Commission meetings;
- Prepare and sign the minutes of meetings and other decisions;
- Represent the Revision Commission in meetings with third parties; and
- Cast a deciding vote at meetings in case of a tie-vote.

The charter or by-laws must specify what constitutes a quorum and define the voting procedures.[147]

Best Practices: The quorum should not be less than half of the Revision Commission members, and decisions should be approved by a simple majority vote.[148]

In addition to annual inspections of finances and operations, the Revision Commission may carry out extraordinary inspections at its own discretion, or be required to do so upon:[149]

- A decision of the GMS;
- A request of the Supervisory Board; or
- A request of a shareholder (or a group of shareholders) owning at least 10% of voting shares.

Best Practices: Extraordinary inspections should start no later than 30 days, either after the Revision Commission receives a shareholder request, or after the respective minutes of the GMS or the Supervisory Board meeting containing a request to carry out an extraordinary inspection have been signed. These inspections should take no more than 90 days to complete.[150]

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[146] LJSC, Article 85, Clause 2, Paragraph 2.

[147] LJSC, Article 85, Clause 2, Paragraph 2.

[148] FCSM Code, Chapter 8, Section 3.1.2.

[149] LJSC, Article 85, Clause 3.

[150] FCSM Code, Chapter 8, Section 3.1.3.

The Revision Commission must prepare a written report on the findings of each inspection.[151]

Best Practices: The Revision Commission should present the results of the extraordinary inspection to the Audit Committee (if established) and the initiator of the extraordinary inspection with the assistance of the company's Corporate Secretary not later than three days after finalizing the inspection.[152]

8. Reporting

a) Inspection Report

The Revision Commission must prepare a report on the results of each annual inspection and present:[153]

- 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.

Best Practices: All Revision Commission members should sign the report and:[154]

- Those who have not signed the report explain why they have not done so; or
- Indicate that a member refused to sign and was unwilling to provide an explanation for such refusal.

Revision Commission members who attend the GMS should provide shareholders the opportunity to ask questions and discuss inspection results.[155]

b) 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

[151] LJSC, Article 87.

[152] FCSM Code, Chapter 8, Section 3.1.5.

[153] LJSC, Article 87.

[154] FCSM Code, Chapter 8, Section 3.1.4.

[155] FCSM Code, Chapter 2, Section 2.1.2.

annual report no less than 30 days before the AGM,[156] 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.[157]

B. The Independent External Auditor

An independent audit conducted by an External Auditor is an important element of the company's control framework. The objective of an audit is to enable the External Auditor to express an opinion on whether or not the financial statements of the company are prepared, in all material respects, in accordance with an identified financial reporting framework, and whether they are reliable. It gives shareholders, managers, employees, and market participants an independent opinion about the company's financial position and, if performed properly, should attest to the accuracy of the statements. An independent audit conducted by a publicly recognized accounting firm normally enhances the company's credibility, and accordingly, its prospects for attracting investment.

Three key points about the independent audit are:

1. Management remains responsible for preparing and presenting the company's financial statements;
2. The External Auditor is responsible for forming and expressing an opinion on the financial statements prepared by management; and
3. The audit of the financial statements does not relieve management of any of its responsibilities.

1. When an Annual Audit Is Required

The Law on Auditing provides that companies must have an annual, independent audit conducted by a certified independent External Auditor (or a licensed audit company), when the company:[158]

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156 LJSC, Article 88, Clause 4.

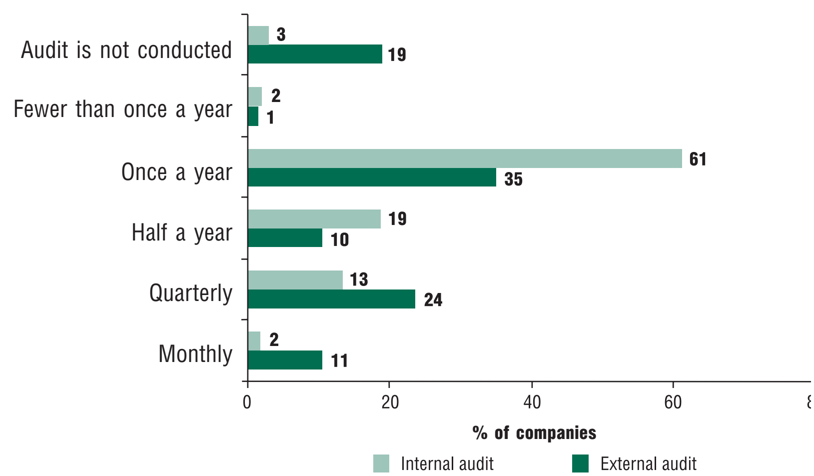
157 LJSC, Article 52, Clause 3, Paragraph 1.

158 Law on Auditing, Article 7, Clause 1, Paragraph 2.

- Is incorporated as an open joint stock company; or
- Has revenues for the reporting year greater than 500 thousand times the minimum wage;[159] or
- Has a book value of assets that, as of the end of the year, exceeds 200 thousand times the minimum wage.

Company Practices in Russia: Figure 2 shows that 61% of regional companies are audited by an External Auditor at least once every year.[160] 34% have external audits conducted more frequently. However, more than one-third violate the procedures set out for the election of the External Auditor in the Company Law in that the are not elected by the GMS. There is also serious concern regarding the independence of the External Auditor (and, by extension, the quality of the assurances provided) in at least one-third of Russian companies.

Figure 2: Frequency of Internal and External Audits



Source: IFC Survey on Corporate Governance Practices in Russia's regions, August 2003

159 The Law on the Minimum Amount of Payment for Labor, Article 4. Currently, the minimum monthly wage is set at RUR 100.

160 IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 29, August 2003 (see www.ifc.org/rcgp).

2. The Rights and Duties of the External Auditor

The External Auditor has the authority to:[161]

- 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;[162]
- Request an EGM;[163]
- Request a Supervisory Board or an Executive Board meeting;[164]
- Receive minutes of Executive Board meetings;[165]
- Receive information from interested parties on related parties and related party transactions;[166] and
- Provide other services as specified by legislation.[167]

➜ *See Section B.4 in this Chapter for a discussion on conflicts of interests when External Auditors provide non-audit services to their audit clients.*

The External Auditor must:[168]

- 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;

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[161] Law on Auditing, Article 5, Clause 1.

[162] LJSC, Article 11, Clause 4.

[163] LJSC, Article 55, Clause 1, Paragraph 1.

[164] LJSC, Article 68, Clause 1.

[165] LJSC, Article 70, Clause 2, Paragraph 2.

[166] LJSC, Article 82.

[167] Law on Auditing, Article 1, Clause 5.

[168] Law on Auditing, Article 5, Clause 2.

- 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.

Best Practices: The External Auditor will often submit, and companies seeking to implement good corporate governance should demand, what is referred to as a 'management letter' in addition to the audit report. This management letter typically covers all material weaknesses in the company's internal control, accounting, and operating procedures. The purpose of the letter is to provide constructive suggestions to management concerning improvements for such procedures.

The findings contained in the management letter are considered to be "non-reportable" to third parties, yet require corrective action by management. Companies wishing to attract external finance should be aware that investors will typically request a copy of the management letter.

3. The Rights and Duties of the Company

The company has the right to:[169]

- 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,

[169] Law on Auditing, Article 6, Clause 1.

as long as the existence of such rights does not contradict Russian (and any applicable foreign) laws.

The audited company is obligated to:[170]

- 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.

4. The Appointment of the External Auditor

The External Auditor is approved by a simple majority vote of shareholders participating in the GMS.[171]

Best Practices: The Supervisory Board should propose candidates for the External Auditor and provide its recommendation to the GMS.[172] However, it is widely considered an even better practice for the Supervisory Board to conduct an open tender for the provision of audit services on a regular basis. The Audit Committee of the Supervisory Board should oversee the selection process, and assess the qualification, expertise, resources, effectiveness, and independence of the External Auditor.[173]

[170] Law on Auditing, Article 6, Clause 2.

[171] LJSC, Article 48, Clause 1, Section 10; Article 49, Clause 2, Paragraph 1.

[172] FCSM Code, Chapter 8, Section 4.1.7.

[173] Audit Committees, Combined Code Guidance, Sir Robert Smith group. Paragraph 5.17. See also: www.ecgi.org/codes/country_pages/codes_uk.htm.

A shareholder (or a group of shareholders) owning 2% or more of voting shares can propose items related to the approval of the External Auditor for inclusion on the AGM agenda.[174]

The AGM agenda must always include the appointment of an External Auditor.[175] Therefore, an External Auditor must be approved for one year until the next AGM. The GMS cannot approve the External Auditor by written consent.[176]

a) 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.[177] The External Auditor must be independent of the company and its management. In particular, an audit cannot be conducted by an audit organization if:[178]

- The External Auditor is the founder, the General Director, the accountant, or other official of a firm responsible for the bookkeeping or accounting of the company;
- The External Auditor is a relative of the founders of the company, its officials, accountants, and other persons responsible for the bookkeeping or accounting of the company;
- The General Director and other officials of the audit firm are the founders of the audited company or its accountants, or are responsible for the bookkeeping and/or accounting of the audited company;
- The General Director or other officials of the audit firm are relatives of the founders of the company, its officials, accountants, or other persons responsible for the bookkeeping or accounting of the audited company;
- The audit firm has been established by the audited company or is its founder (this also applies to subsidiaries, branches, or representative offices of the audited company);
- The audit firm and the audited company have common founders or shareholders; or

174 LJSC, Article 53, Clause 1, Paragraph 1.

175 LJSC, Article 54, Clause 2.

176 LJSC, Article 50, Clause 2.

177 Law on Auditing, Article 3, Clause 1; Article 4, Clause 1.

178 Law on Auditing, Article 12, Clause 1.

- The audit firm provided other services related to the restoration of the bookkeeping and the preparation of financial statements to the audited company during the last three years.

The External Auditor may not have any proprietary interest in the company or its shareholders.[179] All large international accounting firms normally have strict rules that preclude their staff from having a proprietary interest in any of their audit clients.

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.[180]

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.

b) 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. The Company Law does not specify who must sign the contract on behalf of the company. In practice, this is often the General Director. The contract with the External Auditor stipulates the rights and duties of the External Auditor and the company, and may include any additional terms that the parties agree upon.

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079 LJSC, Article 88, Clause 3.

180 The Sarbanes-Oxley Act of 2002, Section 201(a). See also: www.sarbanes-oxley.com.

5. Compensation

The company pays for the External Auditor's services. The Supervisory Board has the authority to determine the amount of the External Auditor's compensation.[181] Clearly, the procedure for the payment of compensation and the amount of compensation must not be made dependent upon audit results.[182]

> **Best Practices:** The amount of compensation for the services of the External Auditor should be disclosed to shareholders.

6. Reporting

The External Auditor presents conclusions on the reliability of the company's financial statements and compliance with accounting procedures.[183] 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.[184] The External Auditor must prepare a report on the annual audit that includes:[185]

- Conclusions on the accuracy of the company's reports and other financial documents; and
- Information on violations of accounting or financial reporting procedures, disclosure rules, and relevant laws and regulations.

> **Best Practices:** The External Auditor should divulge (potential) errors, misconduct, and violations of legislation or the company's internal rules during audits, and report them immediately to the Supervisory Board or its Audit Committee.[186] The External Auditor should make the company aware, as soon as practical

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181 LJSC, Article 65, Clause 1, Paragraph 2, Section 10; Article 86, Clause 2.

182 Law on Auditing, Article 12, Clause 2.

183 Law on Auditing, Article 10, Clause 1.

184 The International Federation of Accountants' International Standards on Auditing (ISA) 700, The Auditor's Report on Financial Statements.

185 LJSC, Article 87.

186 FCSM Code, Chapter 8, Section 4.1.3.

and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the Auditor's attention.[187] The Supervisory Board or Audit Committee should take appropriate steps to remedy these problems.

The format and contents of and procedures for submitting the audit report to shareholders and the GMS are specified by the Federal Standards of Auditing.[188]

Best Practices: The External Auditor should participate in the AGM and answer shareholder questions with respect to the audit report.[189] Moreover, the Audit Committee should evaluate:[190]

- Whether the audit was made in accordance with the established procedures and whether the External Auditor omitted any matters in carrying out the audit; and
- The opinion of the External Auditor before it is presented at the GMS.

If the company plans to seek access to international capital markets, the External Auditor should prepare the report in accordance with the International Standards on Auditing (ISA) issued by the International Federation of Accountants (IFAC).[191]

7. The External Auditor's Liability

Since the External Auditor is liable for civil, administrative, and criminal infractions,[192] he should be adequately insured by a reputable (domestic or international) insurance provider with appropriate coverage.[193]

[187] ISA 400, Risk Assessment & Internal Control.

[188] Law on Auditing, Article 10, Clause 2; LJSC, Article 52, Clause 3, Paragraph 1.

[189] FCSM Code, Chapter 8, Section 4.1.2.

[190] FCSM Code, Chapter 8, Section 4.1.5.

[191] International Standards on Auditing are available on the International Federation of Accountants' website under: www.ifac.org.

[192] Law on Auditing, Article 21, Clause 1.

[193] Law on Auditing, Article 13.

a) Civil Liability

The grounds and terms of civil liability are usually specified in the contract between the External Auditor and the company. The External Auditor must keep information confidential about company operations.[194] If the External Auditor divulges confidential information, the company may seek compensation for the resulting losses.[195]

b) Administrative Liability

The Law on Auditing states that the External Auditor bears administrative liability if he provides the company with an obviously false opinion.[196] In such cases, the Auditor's license may be revoked.

c) 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.[197]

C. The Audit Committee

The Supervisory Board is not legally required to establish an Audit Committee, though it is increasingly seen as an essential element of the corporate governance structure in some countries. While still optional in Russia, the FCSM Code and this Manual recommend that companies establish an Audit Committee.

Key Practices: The Audit Committee typically focuses on three main areas: financial reporting, risk management, and internal and external auditing (see Figure 3).

International best practices suggest that the Audit Committee develop and maintain an internal document, for example a by-law for the Audit Committee,

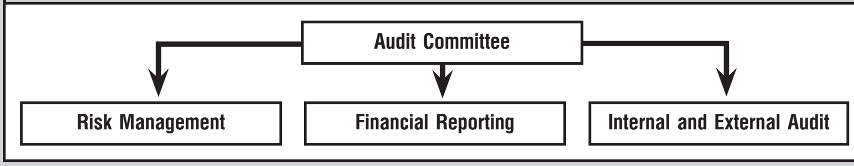
[194] Law on Auditing, Article 8, Clause 1.

[195] Law on Auditing, Article 8, Clause 4.

[196] Law on Auditing, Article 11, Clause 2. The Article defines an "obviously false report" as a report on an audit that was: 1) drawn up without actually carrying out the audit; or 2) based on conclusions that are clearly inconsistent with the audited documents. The report can be deemed "obviously false" only by a court. A false report can also give rise to criminal liability.

[197] The Criminal FCSM Code, Article 202.

Figure 3: The Three Main Areas of Focus for the Audit Committee



Source: IFC, March 2004

that addresses its purpose, duties, and responsibilities. The following are suggested by the New York Stock Exchange (NYSE):[198]

- The purpose of the Audit Committee is to assist the Supervisory Board to oversee the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent Auditor's qualifications and independence, and the performance of the company's internal audit function and independent Auditors, on the one hand; and, on the other, to prepare the report that Securities Commission rules require be included in the company's annual proxy statement.
- The duties and responsibilities of the Audit Committee are to, *inter alia*:
  - — At least annually, obtain and review the report by an independent Auditor;
  - — Discuss the annual audited and quarterly financial statements with management and the independent Auditor;
  - — Discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
  - — As appropriate, obtain advice and assistance from outside legal, accounting, or other advisors;
  - — Discuss policies with respect to risk assessment and risk management;
  - — Meet separately, at least quarterly, with management, with Internal Auditors, and with independent Auditors;
  - — Review with the External Auditor any audit problems or difficulties and management's response;
  - — Set clear hiring policies for employees or former employees of the independent Auditors; and
  - — Report regularly to the Board of Directors.
- Conduct an annual performance evaluation of the Audit Committee.

[198] New York Stock Exchange Corporate Accountability and Listing Standards Committee, 6 June 2002 (see also: www.nyse.com).

1. Functions

The Audit Committee should:

- Develop recommendations for the Supervisory Board on selecting an External Auditor;[199]
- Interact with the company's External Auditor and Revision Commission;[200]
- Control financial and business operations, and oversee the implementation of the financial and business plan of the company;[201]
- Monitor the Control and Revision Service;[202]
- Evaluate the efficiency of internal control procedures;[203]
- Develop internal control and risk management procedures in cooperation with management;[204] and
- Develop recommendations for the Supervisory Board's approval of non-standard operations.[205]

Best Practices: The National Association of Corporate Directors' (NACD) Blue Ribbon Commission on Audit Committees has identified the following indicators of risk that the Audit Committee should monitor and closely examine:[206]

- Complex business arrangements appearing to serve little practical purpose;
- Large last-minute transactions that resulted in significant revenues in quarterly or annual reports;
- Changes in Auditors over accounting or auditing disagreements;
- Overly optimistic news releases in which the CEO (General Director) seeks to cajole investors into believing in future growth;

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199 FCSM Code, Chapter 3, Section 4.9.

200 FCSM Code, Chapter 3, Section 4.9.

201 FCSM Code, Chapter 8, Section 1.1.2, Paragraph 2; Chapter 8, Sections 2.2 and 2.3.

202 FCSM Code, Chapter 8, Section 1.1.2, Paragraph 3.

203 FCSM Code, Chapter 8, Section 1.2.

204 FCSM Code, Chapter 8, Section 1.2, Paragraph 1.

205 FCSM Code, Chapter 8, Section 1.4.

206 The Report of the NACD Blue Ribbon Commission on Audit Committees. See also: www.nacdonline.org. Reprinted with permission of the NACD, 1133 21-st Street, NW, Suite 700, Washington, DC 20031, www.nacdonline.org.

- Widely dispersed business locations with decentralized management and a poor internal reporting system;
- Inconsistencies between Management's Discussion and Analysis (MD&A), the President's letter, and the underlying financial statements;
- Insistence by the General Director or Chief Financial Officer (CFO) that he be present at all meetings of the Audit Committee and Internal or External Auditors;
- A consistently close or exact match between planned results and reported results, and managers who always achieve 100% of their bonus opportunities;
- Hesitancy, evasiveness, and/or lack of specifics from management or Auditors regarding questions about the financial statements;
- Frequent differences of views between management and External Auditors;
- A pattern of shipping most of the month's or quarter's sales in the last week or last day;
- Internal audit operating under scope restrictions, such as the Internal Auditor not having a direct line of communication to the Audit Committee;
- Unusual balance sheet changes, or changes in trends or important financial statement relationships such as, for example, receivables growing faster than revenues, or accounts payable that are continually delayed;
- Unusual accounting policies, particularly for revenue recognition and cost deferrals such as, for example, recognizing revenues before products have been shipped ("bill and hold"), or deferring cost items that are normally expensed as incurred;
- Accounting methods that appear to favor form over substance;
- Accounting principles/practices at variance with industry norms; and
- Numerous and/or recurring unrecorded or "waived" adjustments raised in connection with the annual audit.

2. 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.[207] As a guideline, the qualifications

[207] FCSM Code, Chapter 8, Section 1.3.2.

of Audit Committee members should inspire confidence that they are able and willing to detect accounting irregularities, and act in the best interests of the company and its shareholders. It is, therefore, recommended that only persons of an impeccable reputation be elected to the Supervisory Board and appointed to the Audit Committee.[208]

Because the Audit Committee is an internal structure of the Supervisory Board, it consists solely of Supervisory Board members. The Audit Committee should have at least three members, though this may be difficult for small Supervisory Boards. Other individuals will likely participate in Audit Committee meetings (such as the External Auditor or Revision Commision members). They may not, however, be Committee members.

Best Practices: An experienced individual should chair the Audit Committee. The independence, aptitude, and leadership skills of the Chairman are crucial for the Committee's success.

The Audit Committee should further be composed entirely of independent directors as recommended by the FCSM Code.[209] If this is not practically possible, it is recommended that an independent director chair the Audit Committee, and that the Committee be composed solely of non-executive directors.

➜ *For more information on independent and non-executive Supervisory Board members, see Part II, Chapter 4, Sections C.4 and D.2.*

3. 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. This meeting should occur sufficiently in advance of the Supervisory Board meeting to allow the Audit Committee to communicate its conclusions and allow the Supervisory Board to thoroughly consider them.

[208] FCSM Code, Chapter 8, Section 1.3.3.

[209] FCSM Code, Chapter 8, Section 1.3.1.

The Audit Committee should also:[210]

- Regularly inform the Supervisory Board about violations of procedures and legislation by the company's officers;
- Inform the Supervisory Board about individuals who are responsible for irregularities, the circumstances under which they took place, and how errors can be prevented in the future; and
- Analyze and give recommendations to the Supervisory Board regarding risks associated with transactions and operations of the company.

The Audit Committee should conduct meetings at least once a month to prepare recommendations for the Supervisory Board.[211]

Best Practices: However, meeting once a month may be regarded as onerous and burdensome, as well as costly. The new U.K. Combined Code suggests that Audit Committee meetings be held to coincide with key dates in the financial reporting and audit cycle, with no fewer than three formal meetings per year.[212] The Audit Committee's Chairman will likely call additional meetings to establish an ongoing and informal contact with the Supervisory Board Chairman and General Director.

4. Access to Information and Resources

The Supervisory Board should be provided with information on the financial and operating results of the company.[213] 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.

It is further recommended that the Audit Committee be authorized, and be provided with resources to hire outside audit, financial, legal, and other professional advisors without seeking permission from the Supervisory Board or executives.

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[210] FCSM Code, Chapter 8, Section 2.3.2.

[211] FCSM Code, Chapter 8, Section 1.4.

[212] The U.K. Combined Code on Corporate Governance, Section 2.7. See also: www.frc.org.uk/combined.cfm.

[213] FCSM Code, Chapter 8, Section 2.3.1.

D. Internal Control Function

Internal control is a process conducted jointly by the Supervisory Board, management and the company's employees, the aim of which is to provide a reasonable guarantee that the following company objectives are attained: financial reporting is reliable and accurate, operations are efficient and effective, and the company complies with legislation, and its own internal rules and guidelines.

In fact, an effective internal control structure can help the company:[214]

- Make better business decisions with higher quality and more timely information;
- Gain (or regain) the trust of investors;
- Prevent loss of resources;
- Provide security over its assets;
- Prevent fraud;
- Comply with applicable laws and regulations; and
- Gain a competitive advantage through streamlined operations.

The FCSM Code defines the internal control system as control over the conduct of the company's financial and business operations (including the implementation of its financial and business plan) by the company's divisions and bodies.[215]

1. 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. A system that functions on a permanent basis allows the company to identify deviations on a timely basis, and helps predict deviations in the future;
- Each person involved in the internal control process should be held accountable. The performance of each person carrying out control functions should consequently be managed by yet another person in the internal control system;
- The internal control system should segregate duties. Companies should prohibit duplication of control functions, and should distribute functions

[214] Moving Forward — A Guide to Improving Corporate Governance Through Effective Internal Control: A Response to Sarbanes-Oxley, Deloitte & Touche, January 2003.

[215] FCSM Code, Chapter 8, Section 1.1.1.

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). This organizational separation ensures that internal controls are verified by an independent authority, in this case the Supervisory Board, which is not involved in the implementation or maintenance of internal controls;
- 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. Ensuring the timeliness of reporting on deviations with the shortest possible deadlines allows authorized persons to act swiftly to correct problems.

2. Elements of the Internal Control System

The internal control system includes the following inter-related elements:[216]

1. **Control environment:** The control environment sets the tone of an organization, and influences the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the company's employees and officers; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its staff; and the attention and direction provided by the Supervisory Board.

[216] Internal Control — Integrated Framework, COSO. See also: http://www.coso.org/publications/executive_summary_integrated_framework.htm.

Best Practices: An essential element of an effective internal control system is a strong control culture.[217] It is the responsibility of the Supervisory Board and senior management to emphasize the importance of internal control through their words and actions. This includes the ethical values that management displays in their business dealings, both inside and outside the organization. The words, attitudes, and actions of the Supervisory Board and senior management affect the integrity, ethics, and other aspects of the company's control culture.

2. **Risk assessment:** Every entity faces a variety of risks from external and internal sources. A precondition to risk assessment is setting the company's objectives. Risk assessment is the identification and analysis of relevant risks to achieve company objectives, forming a basis for determining how risks should be managed.
3. **Control activities:** Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities occur throughout the organization, at all levels, and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

Best Practices: Control activities should be as strict on the top as on the bottom of the company's operations, lending credibility to the control environment and the tone at the top.

4. **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. Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. They not only deal with internally generated data, but also information about external events, activities, and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense — flowing up, down, and

[217] Framework for Internal Control Systems in Banking Organizations, Basel Committee Publications No. 40, September 1998, http://www.bis.org/publ/bcbs40.pdf. Note that this document is for banking organizations. However, some of its provisions are equally applicable to companies in the real sector.

across the organization. All personnel must receive a clear message from senior management that control responsibilities must be taken seriously. Further, they must understand their own role in the internal control system, as well as how individual activities relate to the work of others. Of particular importance is that management not limit itself to communicating on a control measure in and of itself, but properly emphasize the meaning and purpose of the particular control element. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators, and shareholders.

5. **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. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs during the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations depend primarily on an assessment of the risks and effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with the most serious matters reported directly to senior management and the Supervisory Board. Senior management and the Supervisory Board need to clearly formulate sanctions to be imposed as a result of control violations on an *ex ante* basis.

3. Bodies and Persons Responsible for Internal Control

Internal control is, to some degree, the responsibility of everyone in an organization and should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with an internal code of conduct or company-level corporate governance code, should such documents exist, or other policy violations or illegal actions.

Best Practices: The company's department responsible for corporate training programs should ensure that all employees and executives receive training on the company's control culture and system.

Further, although each company has its own specific internal control system and bodies, there are some general rules that a company should follow. Internal control always starts at the top of the company, at the level of the Supervisory Board and executive bodies. In particular, the Supervisory Board and executive bodies are responsible for establishing the proper internal control environment and maintaining high ethical standards at all levels of the company's operations. Further, the approval of internal control procedures falls within the competence of the company's Supervisory Board, commonly through the Audit Committee. The Supervisory Board's Audit Committee is also assigned to review and evaluate the efficiency of the internal control system as a whole, and prepare proposals on how to improve it. Finally, the implementation of internal control procedures is the responsibility of the executive bodies.

Best Practices: The General Director is ultimately responsible for and should assume ownership of the system.[218] More than any other individual, he sets the 'tone at the top' that affects the integrity and ethics of a positive control environment. In a large company, the General Director fulfills this duty by providing leadership and direction to senior managers and reviewing the way they are controlling the business. Senior managers, in turn, assign responsibility for establishing more specific internal control policies and procedures to personnel responsible for the unit's functions. For example, controls for the company's IT system should fall under the responsibility of the Chief Information Officer or manager responsible for IT. Of particular significance are financial officers and their staff, whose control activities cut across, as well as up and down, the operational and other units of a company.

The executive bodies, in particular the General Director or the Finance Director would further create structures (services or departments), or assign persons to be responsible for carrying out specific control activities on a daily basis. The Control and Revision Service, as recommended by the FCSM Code, or the Internal Auditor are two such structures.

4. Internal Auditing

Internal auditing is an integral part of a company's internal control system. While internal control is wider in scope, the internal audit can be defined as an independent, objective assurance and consulting activity designed to add value and improve

[218] Internal Control — Integrated Framework, COSO. See also: www.coso.org/publications/executive_summary_integrated_framework.htm.

an organization's operations.[219] It helps an organization accomplish its objectives by introducing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and corporate governance processes.

More specifically, internal auditing reviews and ensures the reliability and integrity of information, compliance with policies and regulations, safeguarding of assets, economical and efficient use of resources, and attainment of established operational goals and objectives. Internal audits encompass financial activities and operations including systems, production, engineering, marketing, and human resources.

Company Practices in Russia: A recent survey of internal audit practices in the Commonwealth of Independent States (CIS) lists typical internal audit tasks:[220]

- 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.

Similar tasks have been identified in research conducted by the Russian chapter of the Institute of Internal Auditors and the Russian Institute of Directors in 2003:[221]

- Conduct traditional internal audits;
- Help safeguard the company's assets;
- Assist management in setting up and maintaining internal controls;
- Consulting services; and
- Fraud investigation.

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219 The Institute of Internal Auditors. See also: www.theiia.org.

220 2002 Internal Audit Survey — Russia and the CIS, Ernst & Young, 2002, pages 9 and 11.

221 Internal Audit in Russian Enterprises, the Institute of Internal Auditors — Moscow, and the Russian Institute of Directors; 2003.

According to a recent survey on internal audit in Russian companies, over 2/3 of respondents indicated that their internal audit function reports to executive bodies,[222] raising concerns over the organizational independence of the internal audit function. Moreover, the survey found that professionals carrying out the internal audit function often lacked necessary knowledge and skills.

In order to function properly, the Internal Auditor should enjoy a reasonable degree of independence. This can be attained by making him accountable to the Supervisory Board (through the Audit Committee) rather than an executive of the company (the General Director or Finance Director).

Best Practices: In reality, it is difficult for the internal audit function to be entirely independent of management. Indeed, the internal control function is a key management tool. It would lose a great deal of its utility if it did not report to management. Cognizant of the need to maintain independence while working closely with management, the Institute of Internal Auditors suggests that the Internal Auditor report administratively to the executive bodies and functionally to the Supervisory Board's Audit Committee.[223]

5. The Control and Revision Service

The internal control function can be implemented by different structures within the company, such as the Internal Auditor or Internal Audit Department. In Russia, the FCSM Code recommends the establishment of a Control and Revision Service.[224] The Control and Revision Service is responsible for the daily internal control of the company's finances and operations, and may also carry out the functions of the Internal Auditor.

Company Practice: In most Western companies, the internal control function is typically carried out by a control department on a daily basis, while the internal

[222] Internal Audit in Russian Enterprises, the Institute of Internal Auditors — Moscow and the Russian Institute of Directors; 2003.

[223] The Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing. See also: www.theiia.org.

[224] FCSM Code, Chapter 8, Section 1.1.1.

audit function is carried out by an Internal Auditor on a periodic basis. Internal control and audit are separate, both in terms of authority and organization. In Russia, it appears that the Control and Revision Service is to play a hybrid function, taking on some of the duties typically carried out by the Internal Auditor, but functioning on a daily basis as if it were a Control Department. In practice however, the Control and Revision Service only sporadically carries out the functions of the Internal Auditor as defined by the Institute of Internal Auditors, at least in the few Russian companies that have created this control body.

a) Authorities

The Control and Revision Service should fulfill the following tasks:[225]

- 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.

The FCSM Code introduces the concept of "non-standard operations", not defined by legislation.[226] Non-standard operations are operations that go beyond the scope of the financial and economic plan of the company. Non-standard operations should receive Supervisory Board approval. Procedures for approving non-standard operations should be set forth in the charter and internal documents.

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225 FCSM Code, Chapter 8, Sections 1.2–1.4; 2.1–2.3.

226 FCSM Code, Chapter 8, Sections 2.2.1 and 2.2.2.

The Control and Revision Service should evaluate the need for and feasibility of non-standard operations before they are conducted, and report its conclusions to the Supervisory Board.

To fulfill its tasks, the Control and Revision Service should have the authority to:[227]

- Receive all documents and materials that are necessary to reasonably and unequivocally monitor whether the financial and business operations undertaken by the management are consistent with the financial and business plans, and the procedures set forth by the company for such operations;
- Check whether all financial documents and materials comply with the company's internal control procedures, such as the approval by department heads of certain documents; and
- Collect all information on (possible) errors and violations that have occurred during company operations, and report all such errors and violations to the Audit Committee.

b) Reporting

To be effective, the Control and Revision Service should report directly to the Audit Committee.[228] It is recommended that the Control and Revision Service hold regular meetings with the Audit Committee to report on the performance of the financial and business plan, and deviations from it.

c) 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. The head of the Control and Revision Service should also have at least five years of experience in a similar function.

The contract with the head of the Control and Revision Service should be signed by the Chairman of the Supervisory Board to protect the independence of the Control and Revision Service.[229] Contracts with employees of the Service should also be signed by the Chairman of the Supervisory Board and not by a member of the executive bodies.[230] The FCSM Code recommends that the com-

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[227] FCSM Code, Chapter 8, Section 2.1.

[228] FCSM Code, Chapter 8, Section 1.1.2.

[229] FCSM Code, Chapter 8, Section 1.3.5.

[230] FCSM Code, Chapter 8, Section 1.3.5.

pany outline the organization and staffing of the Control and Revision Service in its by-laws.[231]

6. Management's Report on Internal Control over Financial Reporting

Best Practices: In May 2003, the U.S. Securities and Exchange Commission (SEC) approved a rule to implement requirements of Section 404 of the Sarbanes-Oxley Act of 2002.[232] Section 404 of the Act directs the SEC to adopt rules requiring each annual report of a company to contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404 also requires the company's External Auditor to attest to, and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board.

Under the final rules, management's annual internal control report will have to contain:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- Management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and
- A statement that its auditor has issued an attestation report on management's assessment.

Russian companies wishing to follow best corporate governance practices should report on these items in their annual report.

E. Summary

Table 1 summarizes the main features of bodies involved in the internal and external audit of the company.

[231] FCSM Code, Chapter 8, Section 1.3.2.

[232] The Sarbanes-Oxley Act of 2002, Section 404. See also: www.sarbanes-oxley.com.

Table 1: Summary of Audit Functions

	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
Status	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
Main Functions:	• Conducts annual inspections of financial and business activities; • Conducts extraordinary inspections; and • Reviews the annual report and financial statements.	• Audits the financial statements prepared and presented by the company; and • Conducts extraordinary audits.	• Develops recommendations for the Supervisory Board on the selection of the External Auditor; • Interacts with the External Auditor and Revision Commission; • Oversees financial and business operations of the company; • Oversees the budget process; • Works with the Internal Auditor and/or Control and Revision Service; • Supervises the development of the internal control and risk management procedures; • Develops recommendations for the Supervisory Board's approval of "non-standard operations;" and • Liaises between all auditing functions, both internal and external.	• Develops policies and procedures for internal control; • Ensures compliance with policies and procedures, as well as with local laws and regulations; • Designs and operates controls to safeguard assets, and over financial and business data; and • Assists in enhancing the efficiency of operations.
Reports to:	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

Table 1: Summary of Audit Functions

	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
Regulated by:	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
Liabilities:	Civil and labor legislation, employment contracts	Civil and audit legislation, civil contracts	Civil and labor legislation, employment contracts	Internal documents, labor legislation, employment contracts
Composition:	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