

# The Board of Directors' Report on Internal Control over Financial Reporting

Guidance on the Swedish Code of Corporate Governance



*FAR is the institute for the accountancy profession in Sweden*



**SVENSKT NÄRINGSLIV**  
CONFEDERATION OF SWEDISH ENTERPRISE

# **The Board of Directors' Report on Internal Control over Financial Reporting**

**Guidance on the Swedish Code of Corporate Governance**

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# The Board of Directors' Report on Internal Control over Financial Reporting

## Guidance on the Swedish Code of Corporate Governance

### 1. Background and Objective

In December 2004, the Code Group presented the Swedish Code of Corporate Governance (Svensk kod för bolagsstyrning), SOU 2004:130, (the Code). The Code specifies, among other things, that the board is to submit an annual report on how the part of internal control dealing with financial reporting is organised and how well it has functioned during the most recent financial year (in the Code this is referred to as the report on internal control). The report is to be reviewed by the company's auditor. The Code also specifies that the board is to submit a special report on corporate governance (Corporate Governance Report). This report is to include a statement on whether or not it has been reviewed by the company auditor. These two reports and the auditor's review(s) are to be appended to the company's annual report, but are not part of the formal financial statements.

This guidance applies to the board's report on internal control over financial reporting and is aimed at facilitating the board's preparation of the report. The main principles on which this Guidance is based have been the standards articulated in the Code, without imposing more far-reaching requirements.

This Guidance is not a static product. Needs and experiences develop over time, as does what is considered good practice in this area. The Guidance is thus expected to be subject to review as experience is gained and practices develop, both in Sweden and abroad.

This Guidance has been prepared by working groups from the Confederation of Swedish Enterprise and FAR, the institute for the accountancy profession in Sweden, see Appendix 3.

### 2. Internal Control

#### 2.1 The Responsibility of the Board of Directors under the Swedish Companies Act

Under the Swedish Companies Act (Chapter 8), the board shall be charged with the organisation of the company and the management of the company's operations. The board shall ensure that the company's organisation in respect of accounting, management of funds, and the company's financial position in general includes satisfactory controls. The board shall issue written instructions setting forth the allocation of duties between the board and the managing director and any other bodies which the board may establish. The board's liability and duty to supervise cannot be delegated to any other party. The board shall regularly assess the company's financial position and, where the company is the parent company for a group of companies, the group's financial position.

## 2.2 Responsibility of the Board of Directors under the Swedish Code of Corporate Governance

According to the Code, the principal task of the board is to manage the company's operations in such a way as to satisfy the owners that their interests in a good long-term return on invested capital are being met in the best possible way. The board is also responsible for ensuring that the company's financial reports have been prepared in accordance with the law, applicable accounting standards and other requirements for listed companies. Furthermore, 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.

The Code specifies the following regarding internal control:

- 3.7.1 The board is to ensure that the company has a sound system of internal controls and keep itself informed of and assess how well it functions.
- 3.7.2 The board is to submit an annual report on how that part of internal control dealing with financial reporting is organized and how well it has functioned during the most recent financial year. The report is to be reviewed by the company's auditors.
- 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.

## 2.3 Definition of Internal Control

Internal control is usually defined as follows:\*)

Internal control is a process, effected by an entity's board, management 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

The basis for internal control is the control environment, which includes the corporate culture that the board and management communicate within and act upon. The control environment provides discipline and structure for the other components in the process. These components include risk assessment within the mandate established by the board and the management, control activities that include both general and more specific controls aimed at preventing, detecting and correcting deficiencies and deviations, systems for internal and external information and communication, and monitoring by the board and the management and onwards down into the organisation to ensure quality in the process.

A framework for internal control is discussed in Appendix 2.

\*) COSO, 1992, see Appendix 2

## 2.4 Internal Control over Financial Reporting

According to the Code the board's report on internal control is limited to financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, the company's board and management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, applicable laws and regulations, and other requirements for listed companies. The process includes those policies and procedures that

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the company,
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, applicable laws and regulations, and other requirements for listed companies, and that receipts and expenditures of the company are being made only in accordance with authorisations for management and directors of the company; and,
- provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

The term "reasonable assurance" refers to the fact that internal controls, though appropriately designed and properly implemented, cannot provide absolute assurance against material errors. There are inherent limitations in internal controls, related to, for example, human errors, fraud and deliberate deviations from established controls.

The term "materiality" is based on the notion that information is considered material if omission or misstatement could influence the economic decisions of users taken on the basis of the financial reports. Materiality depends on the size of the item or error judged in the particular circumstances of the omission or misstatement.

The internal control in the individual company and the evaluation of it are tailored to the risk assessment of the board and management, taking into account that the control activities ensure that fundamental requirements for the financial reports are met, 'financial statement assertions', see Appendix 2.



## 3. Board of Directors' Report on Internal Control over Financial Reporting

The Code does not prescribe mandatory use of an established framework for internal control. For the purposes of establishing a standardised nomenclature and structure in the Guidance it is based on an established framework, see Appendix 2. It should be possible for this nomenclature and structure to be easily related to the circumstances of each company.

According to the Code the board, in its report, is to state how well the internal control over financial reporting has functioned during the most recent financial year. The Code does not refer to criteria to support this statement, for example the term materiality<sup>\*)</sup>.

This Guidance does not prescribe the use of an established framework or the above mentioned criteria to support the statement of the board. Decisions to this effect are a matter for the board and management. This means, among other things, that this Guidance does not include standardised statements on the effectiveness of the internal control over financial reporting.

Guidelines for the disposition of the board's report on internal control over the financial reporting are outlined below <sup>\*\*) .</sup>

### 3.1 General Guidelines

- The board's report is to be prepared on the basis of overall requirements for the information to describe, in a fair and materiality-oriented manner, circumstances of significance in the assessment of how internal control over financial reporting is organised and how well this has functioned.
- The board's report is to be based on the company's circumstances and be characterised by transparency.
- The board's report is to cover the most recent financial year.
- The board's report is to be outlined so that it can be read as a public, stand-alone document without cross-references. It is to be borne in mind when drawing up the description and statement that the report has legal substance both in Sweden and in other applicable jurisdictions.

### 3.2 Disposition of the Report

#### 3.2.1 Introduction

In the introduction to the report the board states that, under the Swedish Companies Act and the Swedish Code of Corporate Governance, it is responsible for internal control and that the board's report is prepared according to the paragraphs 3.7.2 and 3.7.3 of the Swedish Code of Corporate Governance and thus is limited to the internal control over financial reporting. Furthermore, the board states that the report is not part of the formal financial statements. See Appendix 1 for an example of an introduction.

<sup>\*)</sup> Criteria of materiality are used, for example, for risk assessment, establishment of control levels, for the scope of any testing of controls, for evaluation of deficiencies, and for required action in the event of deficiencies.

<sup>\*\*) The board of directors' report on internal control applies to financial reporting in the form of interim reports, year-end reports and statutory annual reports.</sup>

### 3.2.2 Description

- The board gives a general description of how the internal control over financial reporting is organised, taking into account the nature of the business and the circumstances of the company. This description is to reflect principal areas regarding the internal control over financial reporting, see Appendix 2:
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information & Communication
  - Monitoring

If the company applies an established framework for internal control, this is disclosed.

In its description the board also takes into account material changes in relation to the preceding financial year.

- If there is a special internal audit function, which audits the internal control over financial reporting, the report includes a description of the areas of work of the function as part of the company's monitoring, how decisions on the scope of the function are made, and to whom the function reports.

### 3.2.3 Statement

- The board makes its statement based on the evaluation of how well internal control over financial reporting has functioned during the most recent financial year. If material weaknesses have been observed, these are reported, as are any implications for the financial reporting and the steps that have been taken to resolve the weaknesses.
- In companies that do not have a special internal audit function, which performs audit of internal control over financial reporting, the board shall annually evaluate the need for such a function. The board's statement is based on this evaluation and explains the position that the board has taken.

An example of the disposition of the report is set out in Appendix 1.



# The Board of Directors' Report on Internal Control over Financial Reporting for the Financial Year 20XX

## Introduction

According to the Swedish Companies Act and the Swedish Code of Corporate Governance the board is responsible for the internal control. This report has been prepared according to the Swedish Code of Corporate Governance, paragraphs 3.7.2 and 3.7.3, and is accordingly limited to internal control over financial reporting. This report is not part of the formal financial statements.

## Description

*[Control Environment<sup>\*)</sup>*

xxx .... xxx]

*[Risk Assessment<sup>\*)</sup>*

xxx .... xxx]

*[Control Activities<sup>\*)</sup>*

xxx .... xxx]

*[Information and Communication<sup>\*)</sup>*

xxx .... xxx]

*[Monitoring<sup>\*)</sup>*

xxx .... xxx].

## Statement

[The board makes its statement based on the evaluation of how well internal control over financial reporting has functioned during the financial year 20XX].

[In companies that do not have a special internal audit function, the board of directors' statement is based on the evaluation of the need for such a function and explains the position that the board has taken].

Place, MM-DD-20XY

Name

Name

Name

<sup>\*)</sup> The terms for the principal areas included in the internal control need not be used as headings, but are used in this Guidance to show the areas that are expected to be included in the report.

## **Appendix 2**

# **Framework for Internal Control and Principal Areas Related to Internal Control over Financial reporting**

## **Framework for Internal Control**

A framework for internal control provides a common nomenclature and structure for important parts of the practical work on internal control and evaluation thereof in accordance with the intentions of the board and management. A framework facilitates internal and external communication and can be used as applicable, primarily to make it possible to draw conclusions on appropriateness, efficiency and functionality. However, decisions on procedures and measures in the individual company are, and remain, a matter for the board and management.

The framework which has become most widespread, is internationally established and occupies a special position is Internal Control - Integrated Framework, "COSO", launched in 1992 by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). Various categories of interested parties were represented on this committee, including the business community, and this has contributed to broad endorsement of COSO as a framework. The Turnbull Guidance from the UK is also based on COSO. "Turnbull" is a set of guidelines dating from 1999 relating to internal control linked to the Combined Code, issued by ICAEW (the Institute of Chartered Accountants in England & Wales).

COSO describes internal control, divided into five 'components':

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring

Broad descriptions are given below of principal areas in each component relating to internal control over financial reporting. The descriptions support the categories of objectives of reliability of financial reporting and compliance with applicable laws and regulations linked to financial reporting. For detailed guidance, see [www.coso.org](http://www.coso.org).

## **Principal Areas**

### ***Control Environment***

The control environment constitutes the basis for the company's internal control. The control environment contains the culture which the board and management communicate and on the basis of which they act. This control environment principally comprises integrity and ethical values, competence, management philosophy and operating style, organisational structure, responsibility and authority, personnel policies and practices and creates discipline and structure for the other components.

An important part of the control environment is that channels for decision, authority and responsibility are clearly defined and communicated between different levels of the organisation and that normative documents in the form of internal policies, manuals and codes cover all identified principal areas and that these provide the necessary guidance for employees of the company.

### ***Risk Assessment***

A structured risk assessment makes it possible to identify the significant risks relating to internal control over financial reporting, as well as identification of where these risks exist at company, business unit, function and process level. Special consideration is to be given to the risk of irregularities and improper favouring of another party at the company's expense, as well as the risk of loss or misappropriation of assets. The risk assessment results in control objectives which support fulfilment of the fundamental requirements for the financial reports, known as 'financial statement assertions'. Examples of these are given below.

- Existence: an asset or liability exists on a specified date
- Occurrence: a business transaction or event has taken place during the period and relates to the company
- Completeness: there are no assets, liabilities or business transactions which have not been recorded or items for which necessary information is lacking
- Valuation: an asset or liability is recorded and valued according to generally accepted accounting principles and applicable laws and regulations
- Measurement: business transactions are recorded at the correct amount and a revenue or cost is attributed to the correct period
- Rights and obligations: an asset or liability relates to the company on a specified date
- Presentation and disclosure: an item is classified and described according to generally accepted accounting principles, applicable laws and regulations and also requirements to be met by listed companies.

The business operates on the basis of the control objectives to manage the risks within the limits established by the board and management. The risk assessment is to be updated regularly to take account of changes which materially affect the internal control over financial reporting.

### ***Control Activities***

Control activities which comply with the control objectives established are to be designed so that they deal with significant risks relating to financial reporting, including significant accounting principles identified during the risk assessment. Appropriate control activities are to be designed and documented at company, business unit, function and process level and include both general and more detailed controls aimed at preventing, detecting and correcting deficiencies and deviations. It is to be ensured in designing the control activities that they are carried out in the correct manner and at the correct time. General IT controls are to be appropriately designed for the systems which support those processes that have an impact on internal control over financial reporting. Appropriate control activities have been designed for services which are carried out by a third party on behalf of the company.

## **Appendix 2**

Areas encompassed by control activities include, for example:

- proper authorisation of business transactions
- business systems which have an impact on financial reporting, including verification management
- the financial reporting process, including annual accounts and any consolidated accounts and their compliance with applicable regulations in the form of generally accepted accounting principles, applicable laws and regulations and requirements to be met by listed companies.
- material and unusual or complex business transactions and business transactions or valuations of assets or liabilities which contain significant elements of estimates.

### ***Information & Communication***

The company's information and communication channels, insofar as they comprise internal control over financial reporting, are to be appropriate to the purpose and known and enable upstream reporting and feedback from the operation to the board and management. Internal policies, guidelines, manuals and codes are to be communicated to the correct individuals in the operation, the contents are to be known by all and the implications and consequences of deviations from them are to be understood.

### ***Monitoring***

There is to be an appropriate process for regular monitoring and annual evaluation of compliance with internal policies, guidelines, manuals and codes as well as the appropriateness and functionality of established control activities. There is a special process for monitoring that reported deficiencies are remediated.

There is to be necessary information as a basis for the annual evaluation of how well internal control over financial reporting has functioned during the most recent financial year. If there is a special internal audit function, reports from this function may constitute part of the supporting evidence. Other supporting evidence may consist, for example, of self-assessments, reports from regular monitoring or separate evaluations.

## Working Groups and Work Process

Working groups from the Confederation of Swedish Enterprise and FAR, the institute for the accounting profession in Sweden, have together prepared this Guidance for the board's report on internal control over financial reporting.

The work was performed in an initial stage during the spring of 2005, after which a draft proposal (17.06.2005) was circulated for comment. The official period for submitting comments expired on 15.09.2005 and the final Guidance was then prepared.

The result of the comments and the considerations is presented in a separate document, "Remissbehandling, styrelsens rapport om intern kontroll avseende den finansiella rapporteringen" ("Consultation Paper, the Board of Directors' Report on Internal Control over Financial Reporting"), 17.10.2005.

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