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SCHOOL OF BUSINESS, ECONOMICS AND LAW

# Internal control in the wake of the Enron scandal - legislation or self-regulation?

Bachelors thesis in Business Administration,  
Management Accounting

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# Abstract

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**Title:** Internal control in the wake of the Enron scandal - legislation or self-regulation?

**Background & Problem Discussion:** The collapse of Enron together with several other scandals contributed to the creation of the Sarbanes Oxley Act, imposing heavy demands on accounting ethics for businesses listed on the stock exchange in the US. In Sweden, the Swedish Code of Corporate Governance was introduced, but instead of being a law, it is based on self-regulation. The purpose of both SOX and the Code is to gain the trust of potential investors by ensuring that companies are managed as effectively as possible in accordance with the interests and the objectives of the share holders. As both exist for a common purpose, this study will try to answer which one that better fulfills the purpose, by investigating Swedish companies view on the topic.

**Purpose:** This study will try to answer, out of Swedish companies' perspective, what is most effective, self-regulation, with the possibility to either comply or give an explanation for not complying, or detailed regulation by law?

**Delimitations:** This study is limited to investigating companies listed on the US or Swedish stock market. Focus is put on Sarbanes-Oxley Act and Swedish Code of Corporate Governance, in particular their regulation of internal control.

**Methodology:** Initially, laws and regulations were investigated to form a framework upon which further studies throughout the report were based. The empiric consists of eight interviews, which were summarized and analyzed, from which conclusions were drawn.

**Result and Conclusions:** There is no reason to abandon self-regulation. Instead, an overall better framework with some compulsory rules should be developed, in order to provide the best possible help in improving the internal control.

**Suggestions on Future Studies:** It would be interesting to study what view the accounting firms have on the topic. Furthermore it would also be interesting to interview other employees within the organizations, to learn what changes they have observed. Finally, it would be interesting to investigate if companies have a different view on internal control in a few years from now.

## **Acknowledgements**

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## Abbreviations

Big Four, the	The four largest international accountancy firms: PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG
Board, the	The Swedish Corporate Governance Board
CEO	Chief Executive Officer
Code, the	The Swedish Code of Corporate Governance
COSO	Committee of Sponsoring Organizations of the Treadway Commission
FAR	Institute for the accountancy profession in Sweden (Föreningen Auktoriserade Revisorer)
PCAOB	Public Company Accounting Oversight Board
SEC	US Securities and Exchange Commission
SEK	Swedish krona, the currency of Sweden
SOX	Sarbanes-Oxley Act

# Contents

<b>1</b>	<b>Introduction</b>	<b>6</b>
1.1	Background . . . . .	6
1.2	Problem Discussion . . . . .	7
1.3	Problem Statement and Purpose . . . . .	8
1.4	Delimitation . . . . .	8
1.5	Thesis Outline . . . . .	10
<b>2</b>	<b>Methodology</b>	<b>11</b>
2.1	Course of Action . . . . .	11
2.2	Scientific Approach . . . . .	11
2.3	Research Approach . . . . .	12
2.4	Research Method . . . . .	12
2.5	Collection of Data . . . . .	12
2.6	Interview Guide . . . . .	13
2.7	Selection of Companies . . . . .	13
2.8	Research Evaluation . . . . .	14
2.8.1	Validity . . . . .	14
2.8.2	Reliability . . . . .	14
2.8.3	Relevance . . . . .	14
2.9	Criticism of Sources . . . . .	15
2.9.1	Primary Data . . . . .	15
2.9.2	Secondary Data . . . . .	15
<b>3</b>	<b>Theoretical Framework</b>	<b>16</b>
3.1	Corporate Governance . . . . .	16
3.2	Internal Control . . . . .	17
3.2.1	Definition . . . . .	17
3.2.2	Directives . . . . .	18
3.2.2.1	Sarbanes-Oxley Act . . . . .	18
3.2.2.2	European Company Law Directives . . . . .	20
3.2.2.3	Swedish Code of Corporate Governance . . . . .	21
3.2.3	A Brief Comparison . . . . .	23
<b>4</b>	<b>Empirical Research</b>	<b>25</b>
4.1	Interviews . . . . .	25
4.1.1	SOX-Compliant . . . . .	25
4.1.1.1	Company A . . . . .	25
4.1.1.2	Company B . . . . .	27
4.1.2	Formerly SOX-Compliant . . . . .	29
4.1.2.1	Company C . . . . .	29
4.1.2.2	Company D . . . . .	31

4.1.3	Code-Compliant . . . . .	33
4.1.3.1	Company E . . . . .	33
4.1.3.2	Company F . . . . .	36
4.1.3.3	Company G . . . . .	37
4.1.3.4	Company H . . . . .	39
<b>5</b>	<b>Analysis</b>	<b>42</b>
5.1	Sarbanes-Oxley Act . . . . .	42
5.2	Swedish Code of Corporate Governance . . . . .	43
5.3	Sarbanes-Oxley Act versus Swedish Code of Corporate Governance . . . . .	44
5.4	Internal Control in General . . . . .	45
<b>6</b>	<b>Conclusions</b>	<b>46</b>
6.1	Suggestions on Future Studies . . . . .	47
<b>Appendix A</b>	<b>Interview Template</b>	<b>52</b>
<b>Appendix B</b>	<b>An Outline of SOX and the Code</b>	<b>54</b>
	Sarbanes-Oxley Act . . . . .	54
	Swedish Code of Corporate Governance . . . . .	54

## List of Figures

1	The COSO Cube . . . . .	18
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# 1 Introduction

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*This chapter starts out with a background describing how the market lost faith in financial reports due to Enron and other scandals, and how regulations were introduced to regain the trust. The background is followed by the problem discussion dealing with how the Sarbanes-Oxley Act and the Swedish Code for Corporate Governance have been praised and criticized. The discussion leads up to the problem statement and purpose, followed by the delimitations of the study and an outline of the report.*

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## 1.1 Background

With approximately 21,000 (Richard A. Oppel, 2001) employees and revenues of almost \$101 billion in 2000 (Healy and Palepu, 2003), Enron was the seventh largest corporation in the US (Green 2004, p.XII) and one of the leading businesses in electricity, natural gas and communications before its bankruptcy in late 2001 (Matulich and Currie 2008, p.209). The main reason behind the bankruptcy was the revelation of sophisticated and well thought-out frauds, in particular the exclusion of special purpose entities from the financial statements. By entering loans and derivatives in the books of corporations not formally own by Enron, though Enron still carried the risks, whereas revenues and assets went to units included in the Enron enterprise, the illusion of a far better financial position was created, with Enron reporting large revenues, though in reality, they sustained losses. (Green 2004, p.30-32)

As the accounting became subject to inspection of the US Securities and Exchange Commission, SEC (Fusaro and Miller 2002, p.176), several staff members took advantage of inside information and sold their stocks with the market still being unaware of the situation (Vulliamy, 2002). Before matters became publicly known as the Enron Scandal and the share price totally collapsed, the executives managed to sell their shares for a total of \$116 million (Segal, 2006).

Shortly after the Enron scandal, in spring 2002, WorldCom filed the largest petition in bankruptcy in American history. The reason was an accounting fraud of about \$11 billion. Later in 2002 the chairman of Tyco was prosecuted together with two associates for committing theft, stock frauds and for taking large private illegitimate loans from the company. Scandals like Enron, WorldCom and Tyco has brought the attention of the media, and the mass media has shown an increasing interest in irregularities ever since (Finansdepartementet and Förtroendekommittén 2004, p.102). Also in Sweden, the focus on irregularities within businesses and organizations such as Prosolvias, Skandia and Intrum Justitia has proliferated (Finansdepartementet and Förtroendekommittén 2004, p.231). Those scandals have seriously damaged the trust in financial reporting, and therefore serious measures have been taken (Finansdepartementet and Förtroendekommittén 2004, p.232). Rules and regulations have become more stringent, which, inter alia, has elucidated the responsibility of the board of di-

rectors and the management to make sure there are routines and supervision in place to preclude irregularities.

The Enron Scandal combined with advanced bonus systems for executives within businesses such as Worldcom, Tyco and Adelphi Communications contributed to the creation of the Sarbanes-Oxley Act, SOX, imposing heavy demands on accounting ethics for businesses listed on the stock exchange in the US (Finansdepartementet and Förtroendekommittén 2004, p.232). The purpose of the law was to tighten up the legitimacy on accounting and information presented on the stock market and to make greater demands on independency and professionalism on accountants as well as on the internal structures for audit; in addition rigorous penalties were set for violating the law (FAR SRS, 2003).

In the footsteps of SOX, EU has initiated changes to the European Union Company Law Directives regarding corporate governance (EurActiv, 2007). Every member state has its own responsibility for implementing the directives, primarily through national codes (Deloitte, 2007).

The Swedish Code for Corporate Governance, the Code, was initially introduced in 2005, and applied to quoted businesses with a market value exceeding three billion SEK. It was followed by a revised version in 2008, which included changes to harmonize with the European directives (Svernlöv 2008, p.41), and applied to all quoted businesses (Svernlöv 2008, p.19). The purpose of the Code is to gain the trust of potential investors by ensuring that companies are managed as effectively as possible in accordance with the interests and the objectives of the share holders; this is a crucial part of investment decisions, and thus secures the supply of risk capital to the economy (Kollegiet 2009f, p.6). The code complements the Swedish Companies Act, a law consisting of fundamental rules for the organization within companies, by introducing more stringent directives, though deviation is permitted when considered leading to a better internal control, and a proper explanation is given (Svernlöv 2008, p.51).

## **1.2 Problem Discussion**

Every company registered on the Swedish stock exchange with their parent company located in Sweden is required to follow the Code. Furthermore, those registered on the US stock exchange are also required to register with the US Security Exchange Commission (SEC), and therefore have to comply with the SOX requirements (Moeller 2004, p.113). Whereas the Code is only a set of directives, which one can either comply with or give an explanation, SOX is a law with severe penalties for violating it.

In Sweden, the legislation is, to a great extent, built on principles. An individual given a certain task is also trusted to carry it out. In the US, the approach is different; everything not explicitly forbidden is permitted, hence extensive contracts with complicated rules are entered to include every possible outcome. This has led to SOX becoming too extensive, requiring even low-risk areas to be carefully controlled (FAR SRS, 2006), which has received much criticism (FAR SRS, 2005b).



However, the opinions differs, Charles Niemeier, a member of the Public Company Accounting Oversight Board (PCAOB) says that the law has been a huge succes for the average investor and the only issue that should matter is whether US investors can trust the financial statements of public companies. "Fraud has dropped to much lower levels than five years ago" he says. "Is litigation bad for business? Enron is bad for business." (Farrell, 2007)

Over the last few years several Swedish companies, such has Swedish Match (Match, 2007) and Volvo Group (Volvo Group, 2007), have deregistered from the US stock exchange; this gives rise to the question of how much influence SOX had on the deregistrations.

The Code has not been subject to such heated discussions as SOX, though there has been some critical opinions about it. The fact that the Code only briefly treats internal control, in one section, makes it rather unclear (FAR SRS, 2006). On September 4, 2004, Svenska Dagbladet wrote, as a response to the Code proposal, that if the government likes to see new regulations for companies, they should make the regulations law, and not leave them in an unclear intermediate position (Arnhög et al., 2004).

The aim of both SOX and the Code is to provide a public disclosure of the businesses, and to ensure that a good standard is preserved (KPMG, 2008). As the Code allows for deviation, as long as an explanation is given, and it lacks legal sanctions for violating it (Svernlöv 2008, p.45), the question arises how a good standard really can be ensured.

### **1.3 Problem Statement and Purpose**

The purpose of this thesis is to follow up listed businesses' view on internal control and how it has changed during the last few years. In the Western World a number of countries have inducted guiding rules and regulations concerning corporate governance questions (Svernlöv 2008, p.27). This study will try to answer, out of Swedish companies' perspective, what is most effective, self-regulation, with the possibility to either comply or give an explanation, or detailed regulation by law? When both SOX and the Code exist for a common purpose, which one gives the better result in fulfilling the purpose?

### **1.4 Delimitation**

Focus is put on the Sarbanes-Oxley Act and the Swedish Code of Corporate Governance, whereas the European company law directives are only briefly discussed. Both SOX and the Code contain directives that embrace all aspects of corporate governance, but since this report primarily treats internal control, the focus is delimited to the sections concerning internal control, internal control on financial reporting and internal audit. With recent scandals such as Enron and WorldCom, the role of ethics has become an important part of corporate governance; however this is not within the scope of this study, since it is a field large enough for a study of its own.

The research is limited to companies listed on the US or Swedish stock market, otherwise they do not answer to the previous mentioned regulations. Companies not registered on the US stockmarket, with their parent company located outside of Sweden are excluded, since they neither comply with SOX nor with the Code. The focus is limited to larger businesses, i.e. with more than 250 employees and a turnover exceeding € 50 million (Konkurrensverket, 2009), since changes in internal control have a greater impact on larger organizations. Since the purpose is to study companies' view of internal control and how it has changed during the last few years, the interviewed companies must have been around since before the introduction of either SOX or the Code, depending on which one they have to comply with.

## 1.5 Thesis Outline

Introduction	This chapter starts out with a background describing how the market lost faith in financial reports due to Enron and other scandals, and how regulations were introduced to regain the trust. The background is followed by the problem discussion dealing with how the Sarbanes-Oxley Act and the Swedish Code for Corporate Governance have been praised and criticized. The discussion leads up to the problem statement and purpose, followed by the delimitations of the study and an outline of the report.
Methodology	This chapter describes the approach and the method of the research. Initially the course of action is briefly explained, followed by definitions of different approaches and explanations of which approaches this study employs. The chapter further contains an interview guide describing different interview methods and which companies that have been interviewed and how the interviews were conducted. Finally the validity, reliability and the relevance of the report are discussed, as well as the trustworthiness of the sources.
Theoretical Framework	This chapter begins with a presentation of corporate governance, followed by a definition of internal control where the COSO framework is introduced. Thereafter, the forces behind the implementation of the Sarbanes-Oxley Act and the Swedish Code of Corporate Governance are described, as well as their content and expressed opinions about them. In addition European company law directives are briefly discussed, and finally a brief comparison between Sarbanes-Oxley Act and the Swedish Code of Corporate Governance is given.
Empirical Research	In this chapter the conducted Interviews are presented. The interviewed companies are grouped by whether they comply with SOX or the Code.
Analysis	This chapter contains an analysis of the data presented in the empiric, connected to the information provided in the theoretical framework.
Conclusions	This chapter concludes the analysis and tries to answers the question raised in the problem statement. In addition, suggestions on future studies are given.

## 2 Methodology

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*This chapter describes the approach and the method of the research. Initially the course of action is briefly explained, followed by definitions of different approaches and explanations of which approaches this study employs. The chapter further contains an interview guide describing different interview methods and which companies that have been interviewed and how the interviews were conducted. Finally the validity, reliability and the relevance of the report are discussed, as well as the trustworthiness of the sources.*

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### 2.1 Course of Action

A suggestion on subject for thesis was found on the website of KPMG (KPMG, 2009a), on which this report is based.

Initially, laws and regulations, inducted as a result of the scandals and frauds in the first years of 2000, was investigated, to form a framework upon which to base further studies throughout the report. Sources of information have been books, websites, financial reports and laws.

Given the delimitations of the report suitable companies were selected and interviewed to gather qualitative data. Necessary information on whether the companies complied with the delimitations, was found on their websites and in their financial reports. With the framework as a foundation, a number of interview questions were created and sent to the respondents in advance.

Finally, the interviews were summarized and analyzed, from which conclusions were drawn.

### 2.2 Scientific Approach

There are basically two approaches when relating theory to reality: deductive and inductive. In deductive approach, conclusions about separate phenomena are drawn from common principles and existing theories; the decision of what information to collect, how to interpret it and how to relate it to an existing theory is based upon that existing theory. Inductive approach, on the other hand, follows the path of discovery, where a new theory is formed based on empirical data, without the support of an existing theory. (Patel and Davidson 1994, p.21)

Since the purpose of this thesis is to conduct interviews in order to study companies' view on internal control and also to test previous theories, the approach is of both inductive and deductive nature.

## **2.3 Research Approach**

Most researches can be classified based on the previous amount of knowledge within that particular field. When there are knowledge gaps, the researches will try to shed as much light as possible upon the gaps, by comprehensively exploring them; hence those researches are classified as explorative. Within areas where there already exists some knowledge, the research will be limited to thoroughly describe a few aspects of the phenomena of interest, and is therefore classified as descriptive. When several theories have been developed, and the amount of knowledge is large enough to deduce assumptions explaining the reality from the existing theories, the research is classified as explanatory. (Patel and Davidson 1994, p.10-11)

The theoretical framework of this thesis is based on laws and regulations together with existing knowledge within the field; hence that part has a descriptive approach. However, the empiric research is based on interviews to gather information not otherwise available; thus that part has more of an explorative approach. Therefore, this thesis is to be classified primarily as descriptive, but also as explorative.

## **2.4 Research Method**

Basically, there are two types of research methods: qualitative or quantitative. Quantitative researches make use of statistical processing and analysis, whereas qualitative researches make use of verbal analysis. The two methods can be viewed as the end points of a continuum, where researches for the most part can be found somewhere between them (Patel and Davidson 1994, p.12). In a quantitative research, focus is put on the details, which is normally described as an atomic perspective. In a qualitative research, the overall picture is the most important, and focus is put on the underlying meaning and purport (Christensen et al. 2001, p.67).

Since the purpose of the report is to form a holistic picture of companies view on internal control, it was necessary to conduct interviews focusing on companies' general opinions, and try to perceive the underlying purport. Hence, the research in this report uses a more qualitative method.

## **2.5 Collection of Data**

Initially, data is usually collected by studying information already available, to give an overall understanding of the problem. This type of data is called secondary data, and is previously collected for a different purpose under different circumstances. Normally, secondary data is not sufficient for answering all the questions at issue, and in those cases it is necessary to conduct a field-study, to collect the missing information. This data is called primary data, and is gathered by the researcher using different collection methods suited for the problem at hand. (Christensen et al. 2001, p.87-88,102)

This thesis makes use of both primary and secondary data. The information gathered in the theoretical framework solely consists of secondary data collected through

literature, articles, websites, financial reports and acts. The information gathered in the empirical research is collected through interviews, and hence solely consists of primary data.

## **2.6 Interview Guide**

Roughly, there are four different interview methods: structured, semi-structured, unstructured and group interviews. In structured interviews, all respondents are given the same sequence of questions, with standardized explanations, leaving very little room for deviation. In case the respondent needs some clarification, it is given with minimum variation, or rather none at all, by just repeating the question avoiding all personal opinions, interpretations or improvisations. This method makes the answers comparable and easy to analyze by using statistical techniques to find patterns within the given population. In semi-structured interview, the questions are normally specified, but the interviewer is given greater freedom in deepening the answers, and the interviewee is allowed to answer freely and divert to other things. The semi-structured interview is a useful tool when the researcher is interested in a specific topic, and at the same time is employing several methods to yield information about this topic. The unstructured interview makes it possible to reach a qualitative depth by letting the interviewee freely talk about the subject based on his own references. The interview is limited to very few constraints, and might go right off topic. (May 2001, p.148-153)

The interviews in this thesis are chosen to be semi-structured, to maintain comparability and at the same time letting the respondent speak freely. The respondents must be able to reflect upon and elaborate on their reasoning, in order to express their view on the topic.

All interviews except for two were conducted over the phone, whereas the other two were conducted at the respondents' respective offices. Summarized interviews were sent to the respondents for verification. The interview template can be found in appendix A.

## **2.7 Selection of Companies**

Initially, a large number of companies were contacted, among which eight companies within the industrial and technological sector were willing to be interviewed. Sweden has a tradition of companies within these businesses, and therefore there are many such companies large enough to meet the delimitations of this report. Most of them have a stable organization and a strong corporate culture. Among the eight companies, there are two which comply with SOX; two which formerly complied with SOX, but now complies with the Code; and four which comply with the Code, and never have complied with SOX. One of the four latter companies did not implement the Code until the revised version was introduced in 2008.

The interviewed companies are: Atlascopco, Rosemount Tank Radar, Semcon, Volvo Group and four companies that requested to be anonymous. The order in which

the companies are presented in the empirical research does not correspond to the order above, since some of them requested not to be connected to a specific interview. Hence, there is no detailed description of the companies in the empiric, and they are just referred to by an anonymous letter. Since the analysis and conclusions are based on the companies' view on internal control, they are not affected by the anonymity.

## **2.8 Research Evaluation**

### **2.8.1 Validity**

There are two types of validity: internal validity and external validity. Internal validity measures how well the result corresponds to reality, whereas external validity measures to what extent it is possible to generalize (Christensen et al. 2001, p.309).

The thesis should be considered to have a high level of internal validity, since the respondents are responsible for internal control within their businesses. They have great knowledge within the field and are working with internal control on a day to day basis. As for external validity, it is difficult to generalize to all Swedish companies, since only eight companies have been interviewed. But since the interviewed companies span Code-compliant, former SOX-compliant and SOX-compliant companies, it should give an idea of what opinions other companies might have.

### **2.8.2 Reliability**

Reliability is about to what extent a research result can be replicated, when performed in an identical or similar way. The concept contains a double-edged problem. On the one hand, qualitative data is generated by interaction with individuals in a specific connection, in both time and space. With an ever-changing reality, it is thus impossible to collect and measure identical data. On the other hand, the qualitative analyst and the measuring instrument are the same thing. Thus, the reliability can only be connected to the analyst, since no one else can take the shape of him. Consequently, there is no way to repeat the study and reach an identical result. According to Christensen et al. (2001, p.308), the traditional concept of reliability is therefore irrelevant in measuring the value of a quantitative analysis. (Christensen et al. 2001, p.308)

Albeit impossible to reach an identical result, repeating the interviews in this study, using the same template and interviewing the same respondents, would most certainly reveal very similar opinions, given that not too much time has passed. If conducted far-off in the future, the opinions of the respondents might have changed as a consequence of possible changes in the directives or of having a more matured internal control.

### **2.8.3 Relevance**

Relevance measures how meaningful a study is to others. Since recent years has brought many changes to the internal control, this study should be of relevance to

anyone interested in companies' view on internal control. Having found the subject for the thesis on the website of one of the Big Four accounting firms, KPMG (2009a), should also indicate a high relevance. Several respondents also expressed their interest in receiving a copy of the report to learn about the view of other companies.

## **2.9 Criticism of Sources**

### **2.9.1 Primary Data**

Since the respondents are responsible for internal control within their businesses and are working with it on a day to day basis, they should have great knowledge within the field and provide answers that properly describes their view on internal control. Bearing in mind that the respondents are asked to reflect upon and speculate about a few questions, the answers might not be fully thought-out; several answers are also the respondents personal opinions. However, the respondents received the questions in advance, and had quite some time for reflection before the interviews were conducted. Also, the summarized interviews were sent to the respondents for verification, to avoid any misunderstandings.

### **2.9.2 Secondary Data**

Much of the secondary data can be found in multiple locations, which thus allows for verification. In those cases, the most trustworthy sources has been chosen and compared with the other sources to assure the correctness. In the case of referring to the opinions found in different articles, it is not the correctness of the content, but rather the opinions and the fact that it has been discussed that is of importance. A lot of information comes from words of an act, which does not leave any room for source criticism.



## 3 Theoretical Framework

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*This chapter begins with a presentation of corporate governance, followed by a definition of internal control where the COSO framework is introduced. Thereafter, the forces behind the implementation of the Sarbanes-Oxley Act and the Swedish Code of Corporate Governance are described, as well as their content and expressed opinions about them. In addition European company law directives are briefly discussed, and finally a brief comparison between Sarbanes-Oxley Act and the Swedish Code of Corporate Governance is given.*

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### 3.1 Corporate Governance

Sound corporate governance is about making sure companies are managed as effectively as possible in accordance with the shareholders interests and objectives. The aim is to improve the trust that the capital market and the Swedish public put in the companies, and thereby create good conditions for the supply of risk capital (Kollegiet, 2009c). In other words, the purpose of corporate governance is to make sure that companies not managed by their owners are managed in agreement with the will of the owners.

A diverse ownership of quoted businesses, poses an increasing risk that they are not managed in accordance with the interest of the owners. The board of directors and the management might have partly different interests than the owners, e.g. in their view on risk-taking, financial structure, compensations and short-time and long-time profitability requirements. The risk is particularly high in companies without strong principal owners, but the risk more or less exists in every company with owners not participating in managing the company. (Kollegiet, 2009a)

As a complement to legislation, different forms of rules and guidelines for the management have been established, to reduce the risk for conflicts of interest. In several European countries, as well as in other parts of the world, the rules and guidelines has taken the form of codes for corporate governance. In the US, the corresponding development has taken form of legislation and compulsory market rules. (Kollegiet, 2009a)

According to Mårtensson (2006 cited in FAR SRS, 2006), the board of directors probably endorse an increased focus on internal control, whereas the management, whose work is to be controlled, might not be that enthusiastic, even though they most certainly wish for orderliness.

Although outside the scope of this thesis, a few things should be mentioned about the ethical aspects. As the complexity of corporate governance and corporate responsibility is increasing, ethical leadership becomes more important (Peterson and Ferrell 2005, p.74). Thus, codes of ethics has emerged to provide principles to prevent financial misconduct (Peterson and Ferrell 2005, p.62). Ethical goals are no different

from other goals, such as increasing profits or satisfying customers, and when ethics is inflicted and thus becomes integrated into the corporate culture, it may effectively improve the ethical behavior. Corporations involved in scandals, such as Enron and WorldCom, often had codes of ethics that were not a part of the corporate culture. (Peterson and Ferrell 2005, p.78)

## **3.2 Internal Control**

### **3.2.1 Definition**

The overall purpose of internal control is to prevent material errors in the financial report. Accordingly, the intention of a well-working internal control, considering financial reporting, is, inter alia, to ensure that no essential errors are introduced in the income statement or balance sheet. An essential error could be considered as an error big enough to exert influence on the acting of external parties in their evaluation of the company. (Svernlöv 2008, p.149)

In the 1980's and 1990's, the increasing need for a common and full covering definition of internal control gave birth to several different frameworks, primarily in the Anglo-Saxon countries (Föreningen Auktoriserade revisorer, 2006). The most well-spread framework, presented by The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the report Internal Control - Integrated Framework, defines internal control as follows (COSO, 2009):

... a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. Compliance with applicable laws and regulations.

Further COSO describes internal control as consisting of five interrelated cornerstones: Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring. The Control Environment is composed of the culture that the management and board of directors communicate and act upon, and constitutes the foundation for internal control by creating discipline and structure for the other components.

The idea of Risk Assessment is to identify objectives linked to entities at different levels within the organization and to analyze potential risks in reaching those objectives. With the surroundings at constant change, it is necessary to recognize how those changes affect the risks associated with achieving the objectives, in order to manage

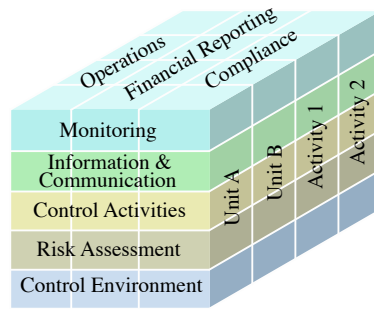


Figure 1: The COSO Cube<sup>a</sup>

<sup>a</sup>The figure is based on <http://www.big4guy.com/images/SOX/Analyzing-COSO-Cube.jpeg>

them. Control Activities are guidelines on how to effectively achieve the established objectives within entities at all levels with the corresponding risks taken in consideration. They include controlling activities to make certain directives are carried out. Information and Communication involves identifying relevant information and, within a due timeframe, effectively communicate it, both downstream and upstream as well as across the organization and to external parties. It is essential that individuals understand their own responsibility and relations to the work of others, and take downstream communication seriously. Monitoring is a process where the performance of the system is measured over time by constant observations, separate evaluations or a combination of both. (COSO, 2009)

A well-working internal control is essential within all businesses and organizations. When properly managed, internal control offers great advantage by providing more effective processes, more reliable information and avoidance of costly shortcomings, and hence engendering greater trust amongst investors. Internal control is to be viewed as a process driven not only by frameworks and directives but rather by individuals at every level of the organization. (Föreningen Auktoriserade revisorer, 2006)

### 3.2.2 Directives

#### 3.2.2.1 Sarbanes-Oxley Act

Corporate scandals at Enron, WorldCom and other companies resulted in two-thirds of all Americans believing that corporate executives are dishonest. Hence, congress responded to public outrage by passing the Sarbanes-Oxley Act, more commonly known as SOX. (Green 2004, p.XI)

SOX was signed into law by Georg W. Bush on July 30. 2002. Originators of the law were senator Paul Sarbanes and republican congressman Michael Oxley (Economist, 2007). SOX was enacted to regain the confidence of investors that had been lost in the scandals and accountancy frauds; they had to be given a guarantee that the financial reports and other information presented on the market were relevant and up to date (FAR SRS, 2003). Still, according to Green (2004, p.XI), fraud or oper-

ational losses will not be prevented , but it will hold a manager responsible for one occurring on his watch. The law covers all American as well as non-American companies that have shares or American Depository Receipts registered on an American exchange or stock market (FAR SRS, 2003), which means that foreign businesses also are bound to follow SOX (FAR SRS, 2005b).

The Sarbanes-Oxley Act created a new regulator to oversee the auditors of public businesses: the Public Company Accounting Oversight Board. Their assignment was to promote informative, fair and independent audit reports in order to protect investors and look after public interest. The establishment, duties, and powers of PCAOB are described in the first title of SOX and five of the Board members are appointed by the Securities and Exchange Commission (SEC) (PCAOB, 2009). SEC is the stock authority in the US and are responsible for the comprehensive and coordinating work within the fields of accounting and auditing (Finansdepartementet and Förtroendekommittén 2004, p.257).

The Sarbanes-Oxley Act is arranged in eleven titles with numbered sections and subsections, but only a small part will be described here. A short description of all titles can be found in appendix B.

Section 202 of the second title requires that the external audit is independent and do not perform any other services for the company (107th Congress, 2002).

Section 302 of the third title prescribes rules requiring the principal executive officer and the principal financial officer or other persons performing similar functions to certify each annual and quarterly report filed (107th Congress, 2002).

The most interesting section for this report is Section 404 of the fourth title, which handles internal control on financial reporting, and of all sections has the most impact on companies and auditors. It directs the managements to identify risks connected to the financial reporting, to introduce controls designed to handle them and to make sure the controls are documented, tested and evaluated (KPMG, 2009b). Furthermore, it requires provability of appropriately designed controls to guarantee that there are no material inaccuracies in the income statement or the balance sheet, which also has to be certified by the CEO and the CFO (Deloitte, 2009). The financial reporting has to include the management's judgement of the internal control, which gives the management a clear deadline. Moreover, the reporting has to be reviewed by the external auditors, who also are to give a judgement of their own. The consequences for not meeting the demands or acting incorrectly might involve severe punishment for the management as well as the external auditors. (KPMG, 2009b) Although it is not required to follow the COSO framework, it is almost essential for achieving compliance with section 404 (Moeller 2004, p.146).

Section 807 of the eighth title states that any person who knowingly executes or attempts to execute a scheme or artifice shall be fined or imprisoned not more than 25 years or both. Section 906 of the ninth title introduces fines of not more than \$5 million and 20 years imprisonment for certifying a financial statement while knowing the report is not in compliance with the act. (107th Congress, 2002)

SOX has been discussed intensively the last couple of years, and it has been both

criticized and praised (Farrell, 2007). There is no doubt that SOX is an expensive business for those companies subject to it. On April 27, 2005 Svenska Dagbladet wrote that a company's expenses for implementing SOX can amount up to over one billion SEK, and Anders Hult (2005 cited in FAR SRS, 2005a), partner and runner of Enterprise Risk Services at Deloitte Stockholm, does not consider the figure to be unrealistic. However, the cost is in his opinion not the central problem, it is the distinction between what is considered sound internal control within the law in relation to previous existing internal control that causes difficulties. He further explains that Swedish corporate culture differ from US corporate culture; in Sweden we have tradition of trusting people to perform their task to the best of their ability without having to write it down, whereas in the US that is not the case. (FAR SRS, 2005a)

Björn Wahlborg (2005 cited in FAR SRS, 2005a), responsible for the central economic division at Astra-Zeneca AB in 2005, says that there is a difference between Anglo-Saxon and non Anglo-Saxon countries, e.g. when it comes to describing a process. In Sweden we are used to give an outline of how different components come together in a process. In Anglo-Saxon companies every step of the process is described in detail, and that is how SOX is designed; full of details and formalities that one have to comply with to the letter. Björn Wahlborg, however, thinks he has observed an advantage with SOX: it brings clarity to responsibilities and roles. (FAR SRS, 2005a)

Anders Hult (2005 cited in FAR SRS, 2005a) says when asking companies if they want a well-working and strong internal control the answer is yes. They are positive about the result of SOX, but the road to compliance is too long. He further explains that companies and authorities in the US seem to have realized that they were trying too hard when introducing SOX. He considers section 404, about internal control system, to be the most laborious for companies. Section 404 is also the part of SOX that SEC thinks has the biggest potential to improve the accuracy and reliability of financial reports. Anders Hult believes that companies do a lot of duplicate work when first implementing SOX, because they are afraid of violating the law. This implicates more work for accounting firms since companies compliant with SOX often hire more than one accountant firm. (FAR SRS, 2005a)

Peter Beusch (2007, p.141) writes that several interviewed Swedish actors only reluctantly implemented SOX because they had to. Further, most of them found SOX very American, and that it applied the wrong logic by imposing strict controls at lower level, though the biggest frauds were committed at higher level within the organizations.

### **3.2.2.2 European Company Law Directives**

At European level, there is no legislation for regulating corporate governance, and during the 90's, EU fell behind in the debate. Hence, in 2002, the Winter Group, a group appointed by the European Commission with expertise in company law, presented their opinion on how to harmonize the corporate governance within the European Union and how to improve it. Subsequently, in 2003, the European Commission drafted an action

plan dealing with the issues presented by the Winter Group. Because of big differences between the member states, the commission did not recommend a common code for corporate governance. Instead, they endorsed all member states to establish individual codes in accordance with the European Company Law Directives. According to the commission, those codes should be based on the "comply or explain" principle, meaning that the companies either have to comply with the code as whole, or provide an explanation that motivates their deviation (Svernlöv 2008, p.27). Recent changes to the eight European company law directive required companies to have independent auditing committees (EurActiv, 2007), and came into force in Sweden on June 29, 2008 (Deloitte, 2007).

As of June, 2008, there were more than 80 codes in about 60 countries according to a summary by the European Corporate Governance Institute (Svernlöv 2008, p.28).

### **3.2.2.3 Swedish Code of Corporate Governance**

Over the years self-regulation bodies, such as FAR SR and the Industry and Commerce Stock Exchange Committee, have continuously introduced a number of directives concerning corporate governance, although before the implementation of the Swedish Code of Corporate Governance, Sweden was one of the few countries without any direct regulation of corporate governance (Svernlöv 2008, p.29). One of the reasons for this is considered to be a fairly well-developed companies act, though several incidents in recent years have exhibited insufficiencies and trespasses when dividing the authority between owners, board and management (Justitiedepartementet, 2004).

The final version of the Swedish Code of Corporate Governance, commonly known as the Code, was presented on December 16, 2004 and came into force on July 1, 2005. The first stage of the Code was developed by a working team followed by a second stage developed by a committee, the Code Group, appointed by the government. (Svernlöv 2008, p.9) It applied to all companies on the Swedish Exchange Market with an asset value of more than 3 billion SEK (Svernlöv 2008, p.19).

In spring 2005, the Swedish Corporate Governance Board, also known as the Board, was established in order to promote sound corporate governance in companies listed on the Swedish stock exchange. (Kollegiet, 2009e)

On February 1, 2008, the Board presented a proposed revised version of the Code. They were of the opinion that the time was right to broaden the application of the Code to all companies whose shares are traded on regulated markets in Sweden. The revised version was developed in two stages, just as the original Code, and had to be adjusted to meet the conditions in which smaller companies operate (Svernlöv 2008, p.19). An overall refining of the Code was carried out, weaknesses and obscurities were removed or improved and the total number of rules was reduced (Svernlöv 2008, p.22-23).

The revised version applies from July 1, 2008 and companies formerly answering to the 2004 version of the Code should immediately adapt to the new Code. Companies to which the Code formerly did not apply should as soon as possible, but not later than January 1, 2009, implement the Code of 2008. (Svernlöv 2008, p.49)

In Swedish stock market businesses corporate, governance is controlled by written rules and practice (Svernlöv 2008, p.51). The intention of the Code is to be an extension of the already existing set of rules and regulations to which Swedish companies have to comply, such as the Companies Act, the Accounting Act (1999:1078), applicable law for annual accountancy and the listing agreements of the stock markets (Svernlöv 2008, p.40). The Code sets a standard for sound corporate governance on a higher level of ambition than other regulations, and thus supplements the legislation (Svernlöv 2008, p.38). It is supposed to encourage a positive development of corporate governance in the companies concerned (Svernlöv 2008, p.26).

The Code is based on the principle "comply or explain", which means that a company that the Code applies to does not have to comply with every rule in it, instead, it is permitted to choose alternative solutions, which are considered to better match the particular circumstances. Such alternative solutions are only permitted given that they are publicly accounted for, and that a motivated reason is given (Svernlöv 2008, p.41-42). The Code has emerged from a Swedish tradition of self-regulation (Svernlöv 2008, p.35), and the Board considers self-regulation to be preferred over legislation (Svernlöv 2008, p.26). In Sweden, the fundamental demands on corporate governance are already established by law and legal agreements for entering the stock markets, and the rules in the Code are for the most part as such that the observance of them is not the most important, but rather the disclosure of how the companies react to them. Hence, the Board do not see any grounds for legislation. (Kollegiet, 2007)

Diverging from one or more separate rules does not imply a violation of the Code, it is the motive for the deviation that is crucial. The company should carefully consider which directions that are suitable for their business and apply them; only then is the Code used the way it was meant to be. (Svernlöv 2008, p.44)

The Code carries no legal sanctions for insufficiently motivated deviations, though it could involve a violation of listing agreements, stock rules, the Companies Act or some other legislation. In that case sanctions specified in the violated law could be called for. It is not permitted to deviate from the Companies Act or binding rules connected with the stock market by providing a reference to the "comply or explain" principle (Svernlöv 2008, p.45). Laws always take precedence over self-regulation (Svernlöv 2008, p.41).

The Board does not supervise or judge how individual companies put the Code into practice. They observe and analyze the Code's application and development, do motivated changes of it and act as a standard-setting body for corporate governance in stock listed businesses. The supervision of how companies apply the Code and if they are doing it adequately are handled by the stock markets at which the companies' stocks are traded, and the judgement lies with the operators of the capital market. (Svernlöv 2008, p.36)

The Code treats the decision-making system, through which the owners directly or indirectly control the company, but it also contains guidelines about how the company should report to owners, the capital market and the surrounding world. (Svernlöv 2008, p.39)

The Code is divided into eleven sections, which can be found in appendix B. The section of most interest for this report is section 10, The audit committee, financial reporting and internal controls. According to this section, the board is responsible for a sound internal control, and that there are formalized routines making sure that the established principles for financial reporting and internal control are followed. They are also responsible for making sure that the financial reporting is established in accordance with the law, applicable accounting standards and other demands for listed companies. In companies with no internal audit, the board must every year evaluate the need for one, and include a motivated standpoint in their internal control statements. According to section 11, the board has to produce a corporate governance report in conjunction with the annual report, and also publish it on their website. The report has to include a separate section describing their internal control and risk management regarding financial reporting, in accordance with section 10 of the Code.(Kollegiet, 2009b)

The Code only briefly treats internal control, and therefore, in fall 2005, the institute for the accountancy profession in Sweden, FAR, produced a guideline for the corporate governance report in corporation with the Confederation of Swedish Enterprise. At the same time, FAR also composed a proposal for how the corporate governance report should be audited and what the auditor should debrief. According to the proposal the auditor should report on executed work and observations but not give their own opinion of the report. Many actors on the market consider this insufficient. (Balans 1 2006)

In their annual report of 2008, the Board reports that the Code has reached a considerable acceptance among companies and has essentially been applied as ambitiously and flexible as it was intended to be. (Svernlöv 2008, p.291)

In June 2007, a working group consisting of the authorities for administration of codes in Denmark, Finland, Norway and Sweden was established. Their assignment was to analyze similarities and differences between their countries' corporate governance and evaluate the possibility for a Nordic coordination within the field. Although a fundamental similarity regarding legislation, regulations, traditions and common praxis exists, the national codes are very different in their designs. The differences cause difficulties for companies with stocks traded at more than one of the Nordic stock markets. As a first step the working group has created a foundation for a continuous discussion about the possibilities for coordination, by forming a clear picture of the corporate governance within the five countries. (Kollegiet, 2009d)

### **3.2.3 A Brief Comparison**

SOX applies to all companies with shares or American Depositary Receipts registered on an American exchange or stock market, whereas the Code only applies to companies listed on the Swedish stock market. The Code is based on self-regulation with the ability comply or explain, whereas SOX is a law, leaving no room for deviations. There are no legal sanctions for not complying with the Code, whereas SOX carries



severe legal sanctions for the violation of it. Where the Code only briefly describes the expectations on the internal control, SOX has detailed rules for all controls, even in low-risk areas. SOX is designed according to Anglo-Saxon tradition with a detailed description of every step of a process, whereas the Code is designed according to Swedish tradition with an outline of how different components come together in a process.

## 4 Empirical Research

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*In this chapter the conducted Interviews are presented. The interviewed companies are grouped by whether they comply with SOX or the Code.*

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The empiric consists solely of eight interviews with companies within the industrial and technological sector. Among the eight companies, there are two which comply with SOX; two which formerly complied with SOX, but now complies with the Code; and four which comply with the Code, and never have complied with SOX. One of the four latter companies did not implement the Code until the revised version was introduced in 2008. As the respondents have connected the questions in different ways and often in different order, and provided different levels of details, each presented interview has its individual structure to stay as close as possible to the original interview.

### 4.1 Interviews

#### 4.1.1 SOX-Compliant

##### 4.1.1.1 Company A

The respondent is head of Assurance and Internal Control within the Northern Europe region. Being a former project leader for implementing SOX at the Swedish headquarter she has been working with the act since October 2004. A colleague from the respondent's division was also present at the interview. He has been working at the company for one and a half year and performs testing and documentation of internal controls. The purpose of the respondent's division is to supervise the internal control and provide a proof of quality.

Since the company is registered with SEC they have to comply with SOX, but with the group headquarters located outside Sweden they do not have to comply with the Code. The company has several divisions spread over the globe, and each division is responsible for their internal control. The head of every internal control unit reports directly to the local CFO, and indirectly to the respondent and her department. The global CFO carries the ultimate responsibility and delegates this responsibility straight down the CFO hierarchy, and the internal audit has no responsibility for internal control whatsoever.

Companies with headquarters outside the US were supposed to be SOX compliant in 2005, but were granted postponement until 2006. The delay was due to the fact that implementing SOX involved a tremendous amount of work with no prior knowledge. The company had to seek assistance from expensive consultants, and even they had limited knowledge about SOX. The respondent explains that she often had to educate and inform her employees without having the knowledge herself. It was clear that

implementing SOX was not a voluntary option, it had to be done, and there were no acceptable excuses. The company spent a lot of money becoming SOX compliant, but since it was a new field with little knowledge, their spent money did not bring them much in return.

Today, the external auditors are not as involved in the company's internal control work as they were when SOX was being implemented. Previously before SOX, the external auditors came at the end of the year to perform their regular audit. Today their visits are more spread out during the year. The external auditors partially rely on the company's results for its testing of its internal control. This means that the external auditors are trying to combine their audit of internal controls and statutory audit in an integrated audit instead. The respondent adds that their external auditors have before the implementation of SOX never spoken with so many people within the organization. Previously, contact was much more concentrated to only talking to the Controlling, Accounting and Finance Departments.

The company carried out controls before the implementation of SOX, but they have never been as formally documented as they are today. The implementation of SOX resulted in more controls and more documentation. The company formed a new central function, a department for internal control, and the respondent therefore jokingly says that she and her colleague have employment thanks to SOX. The fact that the company appointed an employee at every unit to become responsible for its internal control has increased their number of assignments.

COSO is nothing the respondent and her colleague use in their day-to-day work, but the colleague mentioned that they did look at it as they were implementing SOX, and that it has been utilized by the Group when designing their control environment.

The respondent finds it hard to determine how internal control has created value, but she states that they have achieved a better risk awareness. The tests that they have performed provide a clear picture of the transactions, and help them identify and solve problems. They have also improved their IT and information systems, and developed a better process thinking within the organization.

Their initial respond to SOX in 2004-2005 was confusion and panic, but today they have reached an understanding of the demands that need to be placed on a good internal control environment. The respondent admits that SOX has brought a lot of extra work, but she believes that in a couple of years it will be fully integrated in their daily routines. There are many people complaining about SOX, but the fact is that the act has brought orderliness.

The respondent does not find it necessary to change SOX, but she would like to see some changes in her company's methodology. SEC and PCOAB have introduced some changes, which other companies have taken in, and in her opinion the company should take advantage of the possibilities those changes have brought.

If SOX were not mandatory, the company would not have implemented the time-demanding process of formally testing the internal control every year. Instead, they would have tested the internal control with methods based on common sense and sound

judgement. According to the respondent, they would have introduced changes in the internal control despite the entrance of SOX, but not to the same extent. Without SOX they would have focused more on high risks and less on low risks.

When material weaknesses reach a certain level it has to be reported to SEC, which is something that has never occurred at this company. For the investors, this fact is an indicator of a well-working internal control, and together with their products, service et cetera, it contributes to a positive image of the company.

The negative effects of SOX are the costs. It was extremely expensive to implement it and it is still fairly expensive to stay compliant. The costs for external auditors are still high, but the respondent hopes to be able to lower those costs, by further integrating the regular audit with the SOX audit.

The heavy sanctions associated with violating SOX are connected with lying and not with shortcomings, and therefore the respondent does not find them unreasonable. She further adds that of course one can argue that manslaughter gives you ten years whereas fraud gives you twenty, but at the same time fraud does affect a large number of people (i.e. can affect people's retirement funds, et cetera).

As for future scandals the respondent believes it will be hard to prevent them. It is difficult to predict what a number of intelligent people conspiring in a hotel room have in mind. If they want to commit irregularities, it is still possible. An instrument that the company uses to prevent conspiracy is a hotline allowing for anonymous calls. An independent party within the company investigates everything reported to the hotline.

The respondent says that they have built a well-working internal control environment, but expenses and ineffectiveness is still a problem. Some controls have already been automated, but there are more to come. In the future, they have to keep doing what they are already doing, but they have to do it more efficiently.

#### **4.1.1.2 Company B**

The respondent started working at the company as a controller nine years ago. Before that he worked as an auditor for one of the Big Four. Since 2005 he works at the financial department at group level. He is primarily working with internal control, and they have someone else responsible for internal audit.

The company has a parent company in the US, and therefore has to comply with SOX. They have a delegated financial responsibility, which imposes high demand on internal control. The financial department bears the responsibility for the practical realization of internal control and that everyone conforms to their policies. The head of the financial department reports to the CFO, who quarterly certifies the internal control, and also shares the ultimate responsibility together with the CEO. Every second year the company performs a three-week internal audit with auditors coming from the parent company in the US. The internal and external auditor barely has any co-operation; they are just demanding to view each other's audit memorandum.

The company does not directly work with the Code; the conclusion is drawn that following SOX automatically fulfills the obligations of the Code. Since a statement about the Code has to be included in the annual report, the external auditors keep track of the Code, to make certain nothing is overseen.

As the company adapted to SOX, they went through a whole battery of questions. They had to make sure there was dual control in place everywhere, fill in the gaps of the enterprise resource planning and make sure that only qualified persons could place an order and that every order was approved by the order manager. The creation of the process descriptions was not a sole product of the financial department, but rather involved the whole company, where every unit had to describe their workflow.

The respondent believes that Swedish companies are well prepared for SOX, as many parts of SOX go without saying. Many things were already deep-rooted; the hard part was to review and document everything.

The respondent finds internal control to be of utmost importance, and the more the business grows, the more important it gets in order to be able to trust the internal flows one hundred percent. Sound internal control also gives the company a quality label.

The respondent is of the opinion that demand for more detailed internal control rules positively contributes to the business and management of it; the more system controls the better. SOX has made it easier to tighten up the internal control; it is good to have something to back you up and SOX gives you a strong argument when meeting with people within the company, the respondent says. But the rules should not be taken to absurdity; certain dual controls are simply not implementable in smaller businesses. Thus, SOX should be more customized to the size of the business.

The introduction of SOX has resulted in some changes for the company: now they have to make sure to regularly update the documentation of the routines; they have people coming from the parent company reviewing their work; there is one additional step in the reporting process; and the awareness has increased. Implementing SOX has involved a tremendous effort, but the extensive work has been for a good cause. Now, afterwards, the extra workload has decreased a lot, but increases every time the audits are performed. The most difficult thing about SOX to implement has been all dual controls it requires, and that changes in the sales ledger are not permitted to alter invoices.

Now, when the routines are ingrained, the company generally has a positive attitude towards SOX, though it has been a tough journey, where the financial department initially was very tied up. Once all obstacles are overcome, and the objectives are in clear sight, SOX is a well-working set of rules and regulations. The respondent is of the opinion that SOX brings stability to the company; e.g. changing the enterprise resource planning required much less effort with all the SOX routines in place. Since their adaptation to SOX for the most part involved describing what was already done, the respondent cannot see that SOX has made it easier to discover and become more aware of financial risks. When asked about the heavy sanctions associated with SOX, the respondent believes that wrongdoing should be punished, but that it is tragic that

sanctions should be needed.

If the company were not subject to complying with SOX, they probably would not have worked more with internal control than they already did, since their internal processes already were running well.

The respondent does not have much to say about the Code, since they are not particularly looking at it, but he does find the idea of "comply or explain" good, and would that SOX allow for that as well, given that a well-documented explanation is required. Moreover, he believes that foreign investors find SOX more stable than the Code.

The respondent believes that the Code, SOX and other laws and directives are important to improve the trustworthiness of companies, but that it is a shame that it should be needed. He particularly sees a need for it in the former Eastern bloc, whereas he finds us a bit naïve in Sweden, where we have had management audit for decades. Therefore, he says it feels a bit odd having to prove what they have already been doing for a long time by documenting everything.

The respondent hopes that the Code and SOX helps avoiding future scandals, although he believes that it is hard to prevent them by laws and directives. He says that in order to bring a scandal about, many persons need to be in collusion, and therefore the laws and directives must at least be of some help. It is usually the least likely that commit fraud; opportunity makes the thief, but there should be left no room for opportunities. To help revealing conspiracies, the company provides a hotline for whistleblowers. The respondent definitely believes that internal control rules contribute to protect the owners' investments and the company's assets, but he doubts that it would do any good if the management were to plan for irregularities. He further believes that SOX is here to stay, and that there will be greater demands on control in the future. He would also consider it good with a global standard.

#### **4.1.2 Formerly SOX-Compliant**

##### **4.1.2.1 Company C**

The respondent has been responsible for internal control at his company for the last seven years. There is no principal owner and there is more than 50 percent foreign ownership, where the largest share is foreign funds.

There is a rather small central division for internal control in Stockholm, while every geographical region has its own local responsibility. The local sites have to make sure there is internal control in place, which in turn is monitored and verified from Stockholm, where they work a lot with consultants. The work with internal control is summarized and reported directly to the audit committee, which is a part of the board. This work is very similar to the work reported by the external auditors, also directly to the audit committee.

When asking the respondent about more detailed demands on internal control, the respondent has difficulties in understanding how someone from outside the company should know better than they; they already have the internal control they see need for, and then someone else, who knows nothing about their business, comes and tells them how things should be done. This sounds like madness to the respondent; he does not wish for more detailed control rules in the Code.

The respondent finds the emergence of the Code a bit silly, but there is nothing particular he would like to change about it. The Code has not affected the company in any essential way; they already had most routines in place beforehand. One deviation is made; they are of the opinion that reviewing the six or nine months' report would only bring them an extra million or two in audit fees without providing any additional value, and have therefore decided to leave that out. The relation between the internal and external auditor as changed less than wished for; there is collaboration now, which might not have been there before, but it has not lead to less effort for the external auditors.

The respondent does not believe that following the Code instead of SOX, or following the Code at all, has any impact on investment decisions. In fact, he believes that the Code is rather unheard of.

It is hard to say that the internal auditor has an independent role. To prove that, there must exist a case where the auditor has overruled the management and gone directly to the audit committee, which has never happened. It is easy to claim that the internal auditor is independent, but it is hard to tell if the auditor really would override the management. Furthermore, the respondent does not believe in the American idea of a whistleblower, as there is a high risk that the whistleblower would face consequences.

The respondent finds the "comply or explain" principle excellent, since that allows for not complying with foolish rules, and instead explain why they are foolish. This is a way to handle the problem that someone from outside the company believes to know better.

SOX was not the direct reason for unregistering with SEC and leaving the US stock market. The whole idea of being listed there had its origins in the 80's and 90's, and was to gain access to the US capital market. Today the capital market acts differently; a US shareholder, who wants to buy shares, buys them at the Stockholm stock market. The whole financial market has become internationalized and looks totally different than in the 80's. Thus, the whole idea of being listed there has vanished. What they had long been annoyed with was not SOX, but rather SEC as a whole, since they have an enormous amount of detailed rules, which are rather hard to comply with. Therefore, they wanted to unregister with SEC even before SOX came, which at that time was impossible. But as SOX was introduced it created a lot of stir outside the US; non-US companies found SOX unacceptable, forcing SEC to accept rules allowing for unregistering with them. As the new rules were introduced, the first thing the company did was to unregister. Although SOX was not the primary reason, they were very happy to be spared from it, since it is composed of detailed rules and is very expensive to comply with.

As they initially had to comply with SOX in 2006, they put an enormous effort into implementing it followed by enormous costs. They were considered SOX compliant by themselves and their auditors as per December 31 in 2006, and were able to sign all the certificates. But just as they were ready to file their compliance with SEC, the rules were changed, and they left SEC without filing with them at all. Despite leaving, their view on internal control for financial reporting still carries a lot of influence from SOX.

The respondent deems SOX extremely bureaucratic, and can hardly see any positive aspects about it. SOX is very American, with a lot of detailed rules, and as long as you can show that you have followed the rules, you will not get sued. One advantage with SOX was that everyone knows how strict American laws are, with liability to punishment, which made it much easier to make people pay attention to the new rules introduced when they were improving their internal control.

The respondent cannot tell if the Code has helped improving the companies' trustworthiness. The Code requires the companies to write a report on corporate governance, which might improve the trustworthiness, but everyone would be free to write one anyway, regardless of the Code. Moreover, he believes that rules for internal control contribute to protect the owners' investments and the companies' assets, and that internal control provides orderliness, which helps discovering suspicious transactions.

The respondent does not believe that the Code or SOX will prevent future scandals the slightest. The scandals will always emerge in areas that the Code or SOX have not considered, and there will always be people breaking the rules, be it a law or a voluntary code.

When asked about legal sanctions for breaking the rules and directives, the respondent says it is madness to have such hard penal sanctions as in the US, but points out that we also have some sanctions in Sweden, e.g. for breaking the Companies Act. Furthermore he considers such sanctions an ineffective solution, and he also believes that it is hard to carry them out. He says that one might afford to pay penalties in the amount of one or two millions, but it is not anything one would like to put on show; the companies are more worried about bad reputation than paying penalties.

Since EU does not have much else to do than making up new rules, the respondent thinks that the future will bring more laws instead of self-regulation. He finds this a bit problematic, since it is the contrary to how we work here in Sweden.

#### **4.1.2.2 Company D**

The respondent has worked at the company for the last 30 years. Before he became financial manager, he worked with IT-systems for financial reporting, and today he works with internal control.

The work with adapting to SOX started out in 2003, where they tried to figure out how



to live up to SOX with minimal effort. In 2004, a quality project with many details took shape. The project, which the respondent became a part of, was very expensive and largely driven by auditors. Together with a few other Swedish companies, which also had to comply with SOX, they formed a benchmark group, to facilitate the adaptation to SOX. During 2004 and 2005, there was a lot of work documenting everything; 2005 was spent assessing all the controls; and 2006 brought a tremendous amount of work testing everything. Though the testing still carries a heavy workload, the burden has decreased by some 75 percent.

In summer 2007, the company unregistered with SEC even though a light version of SOX was presented. The reason for unregistering was not only SOX, but that it was very expensive just being registered with SEC, and a lot of papers needed to be filed. As heavy sanctions were pressing on in meeting the requirements of SOX, an important task after unregistering is to keep the internal control alive when law no longer requires it.

The work with internal control that was initiated by SOX has been a good investment. Too much trust has been put in the IT-systems in the past, and a lot of previously lost internal control routines have been brought back. Since the withdrawal from SEC, the company has dropped parts of SOX they considered too complex and complicated. Today, the company tests about 60 to 70 percent of the controls instead of 100 percent as SOX imposes. The respondent believes that SOX actually was intended to be like their internal control is today, but that the auditors have blown it up out of all proportion.

The work with internal control has led to less work for the external auditors, and the respondent hopes that they will work more closely together in the future, to lower the external auditor costs even more. From the respondent's point of view, internal control adds extra value by creating a common view, orderliness, lower external audit fees and being able to trust the figures in the closing of the books.

The company has always worked with internal control, although not as methodical as today. Before the introduction of SOX, a lot of controls were performed without any documentation. Documenting the control procedures makes it possible to measure and evaluate the internal control, and also to observe interconnections.

SOX has made it a lot easier to discover financial risks, and given a great advantage for those working at the accountants department, since they now can put greater trust in the figures. It is important to take care of how SOX has changed the work with internal control, but in a simpler and less expensive way; SOX is a bit too complicated and too much auditor-controlled.

The respondent is of the opinion that complying with the Code or SOX increases the trustworthiness of the companies, but he finds the Code a bit diffuse. He would rather that the Code required companies to follow a certain structure. Furthermore, he finds laws to be most effective during recession, when no one seems to have time for internal control, and he sees it fit to introduce laws in Europe as well. He also believes that there will be future laws with clearer directives, and that the European Union will

introduce something like EuroSOX. He does not think laws will prevent future scandals, since the scandals depend on the intent of the management, which is very hard to control by law.

The respondent has no comments on whether not complying to SOX anymore has affected investors view on the company.

### **4.1.3 Code-Compliant**

#### **4.1.3.1 Company E**

The respondent started working at the company about ten months ago. Before then, he was working four years for a large firm of accountants, where he spent his first two years as a project leader for big SOX projects, in which they worked both as auditors and as consultants for large Swedish companies. The last two years he worked at the forensic services department, investigating irregularities, frauds, embezzlements and suchlike things.

Being an industrial enterprise that has been around for a long time has led to a sound internal control culture. Since rules and regulations are more or less gibberish to many, the culture has been based on common sense and ordinary sound control.

The overall responsibility lies with the board of directors, and since the introduction of the Code, they have established an audit committee responsible for the more practical work of monitoring the internal control process. At present time, the respondent is head of internal control, a department consisting of him only, which is responsible for operational control activities. Before the respondent was employed, the company had someone working half time running the internal control and half time as a group controller. This person also hired several consultants to perform a lot of the internal control work as well as internal audit. He soon came to the conclusion, just as the respondent did when he started, that internal control and internal audit should be kept apart, since it is hard to stay independent while doing both. The respondent reports directly to the audit committee, consisting of the chairman and two other members of the board. The reporting takes place in connection to the quarterly financial statements as well as a few more times per year, and in turn the committee brings it up on the following board meeting.

As the respondent started at the company, they had started composing a self-assessment form, built on COSO, but their internal control work lacked detective methods for discovering financial risks. Having previously worked a lot with SOX, the respondent selected the best parts and constructed a new internal framework for internal control. One argument for introducing it was to save money on external auditing, which is very expensive. The idea is to make sure that the financial risks viewed by the company are in accordance with those of the external auditors, and to provide documentation of how they face those risks with both detective and preventive methods; hence they can save a lot of money on external auditors, since the auditors only has to do a re-performance

of the work already done. Another argument was to be prepared for a future addition to the Companies Act, saying that the companies have to make a statement about the effectiveness of the internal control. Making a statement about the effectiveness is almost impossible without testing the internal control, which brings us one step closer to SOX.

Improving the internal control helps focusing on what is relevant and creates additional value by lowering the external audit costs, facilitating the finding of ineffective transaction flows and making it easier to detect financial risks that might cause material errors in the annual report. A better internal control helps finding both accounting and operational risks, but the respondent emphasizes the importance of keeping them apart. The Code, he says, deals more with accounting controls than operational controls.

The respondent strongly believes that imposing heavier demands on internal control positively contributes to the business and management of it. He has seen CFOs in Sweden bringing home financial manager from Asia, just to have them explain why they have not performed the internal control they were supposed to; this is something that would never happen if internal control was not regulated by law. Having a law is helpful in making everyone within the company focus on internal control.

The two major changes since the introduction of the Code were the creation of the internal framework, and the establishment of the audit committee. Although the Code probably was the reason for creating the framework, it implements a more thorough internal control than the Code demands for. The Code has not posed any particular challenges, and the company complies with everything. In view of the fact that their internal control is more comprehensive than the Code asks for, they do not pay it much attention, and therefore they do not have any particular attitude towards it.

Initially there was a lot of work changing the internal control routines; it required a lot of teaching and learning along the way, trying to find proper control objectives and relevant risks. There has been many confusions, but eventually it will only be a matter of performing the controls.

The respondent does not believe that the introduction of the Code itself has made it easier to become more aware of financial risks within the company, since they already worked on finding them before. Furthermore, their relation to the external auditors has changed towards working more closely with them, making sure that both parts are looking at the same financial risks.

Today, there is no internal auditor at the company; thus, in order to have an independent internal auditing, the respondent sees two solutions: either employ more people at internal control or hire consultants to perform the auditing.

The respondent appreciates the fundamental idea about SOX, but finds the focus a bit askew. He considers SOX imposing too detailed control in low-risk areas and too weak control at higher level when e.g. reversing big entries in the 100-million dollar size. To further clarify, he says that a person who works at a financial department will most likely make sure that the invoices are attested and has not much to gain in

doing otherwise, whereas someone working at the top might have a lot to gain, and can commit much bigger frauds. The first companies complying with SOX had lot more detailed control and key figures than they have today, owing mainly to the fact that audit firms made things more complicated than they actually were.

The respondent finds it a bit unclear what the minimum requirements of the Code really are, and since there is no call for the external auditors to review the corporate governance report yet, he fears that it is easy to get away by just claiming to comply. Moreover, he sees no reason for including more detailed rules or any legal sanctions in the Code; he would rather that it contained an overall better framework with clear minimum requirements and that the upcoming requirement for the external auditors to review the corporate governance report became effective. He believes that more detailed rules would only get out of hand. When asked about the "comply or explain" principle, the respondent finds it insufficient; he wants to be able to verify, measure and obtain an independent result.

The respondent does not believe that complying with the Code in any way affects the valuation of the company, or that foreign investors are much interested in whether companies comply with SOX or the Code. He has never heard about any feedback from the owners regarding compliance with the Code, and he believes that as long as one of the Big Four performs the auditing, they are rather more interested in the result and the financial progress. Seeing that scandals have attracted a lot of attention, the respondent takes it that the Code contributes to improving the trustworthiness of companies, but he is further convinced that the top management reacts more to scandals than the Code, since none of them would like to be put in such light themselves. As scandals occur when there is no insight into the company, the respondent believes that the Code somewhat helps preventing future scandals by adding disclosure to the companies, but it gives absolutely no guarantees; he has seen scandals and irregularities occur even in SOX companies. Furthermore, he is of the opinion that the Code itself does not help protecting the owners' investments and the company's assets; he believes that it is rather how the companies choose to implement their internal control that helps protecting them. The respondent's company has therefore adopted the whistleblower concept.

When asked about the future, the respondent believes that COSO will remain the primary framework for their internal control, and he also believes that having an electronic invoice system and automating controls will solve many risks. The company will continue working on improving the control of the IT system, to get rid of such things as old controls implemented in Excel by someone not working there anymore. In general, the respondent believes that the rules for internal control will tighten up a bit, but he does not believe there will be any EuroSOX, as some people flag for.

#### 4.1.3.2 Company F

The respondent is Vice President for Group Internal Audit & Assurance at his company. The group, consisting of six members spread around the world, was appointed in 2008 and has responsibility for internal control and internal audit processes. Though the group is fairly new, the company had internal control and internal audit before that as well, for which the respondent also was responsible in the position as Group Controller. The respondent reports directly to the CFO and the audit committee.

The company has a decentralized organization, where every general manager is responsible for having an internal control within his corporation. The manager is supported by a business controller, and reports to a responsible division. Auditors from the internal audit and assurance group review the internal control with assistance from other employees within the organization, as well as by the external auditors. There is also a self-assessment system, in which the general managers and their management team have to answer a large number of questions, which in turn are evaluated on a global level.

Since the introduction of the Code, the company has reinforced the internal audit and focused more on internal control, although the respondent states that this progress was not driven by the Code; they were continuously upgrading and improving the internal control before that as well. However, the Code might have contributed to the intensified focus and activity; for example the number of follow-ups has increased. The company complies with everything in the Code, and they faced no particular problems implementing it. The respondent explains that they met the terms of the Code even before it was required, and they have not changed their way of working, they have only started working more actively. Perhaps, he says, the Code has had more influence on corporate governance concerning the board and matters at the shareholders' meeting, than on internal control.

The relation between the internal and external auditor has not changed much; however, the respondent is of the opinion that the most ideal would be to have the external auditors controlling and verifying the figures, and leave the internal control to the internal auditors.

The respondent believes that demands for a more thorough internal control contribute to protecting the company's assets, and that it creates value by unifying the group and providing common principles. In order to manage a company, there need to be control in place.

The respondent has a positive attitude towards the Code and finds it constructive. He does not wish for any particular changes of the content, but in his opinion it is better with guidelines that companies should follow, and he would like to see the "comply or explain" principle phased out over a transition period. He definitely does not want any detailed management rules included in the Code; the Code should provide broad outlines and leave the details to be designed by the company itself, he says.

When asking the respondent about SOX, he says that they have in-house knowledge about it, but it is nothing they use actively. He is glad though, that they do not have to comply with SOX, because it involves a lot of bureaucracy and documentation, and is driven by sanctions, which in his belief, is not the best practice. Discussing it with colleagues has given him the impression that SOX initially was a big impenetrable bubble, but now some years later might have matured into something useful.

The respondent does not stand in direct contact with the company's investors, but he has never received any indications of the Code not being sufficient for them.

By focusing on internal control the company protects its resources, but the increased focus, as mentioned earlier, is not driven by the Code. Questions concerning internal control have arisen within the business world, partly because of scandals and irregularities, and have driven companies to improve their internal control. As for future scandals the respondent does not believe that they are prevented by the Code, but that the increased focus will reduce them.

The Code has to some extent contributed to enhancing the credibility for companies' financial reporting, but not so much to improving internal control. The respondent thinks that the section in the Code regarding corporate governance, or more specific the board, has had greater effect on increasing the reliability.

In the future, the respondent believes that a EuroSOX might be introduced, but not of the same proportions as SOX. He is nevertheless certain that we will be facing a co-ordination and internationalization of rules within the EU and an increased focus on irregularities. If a legislation followed by legal sanctions were to be implemented in the EU, he would find it very sad. He believes it is more important to convince investors, managers, owners and the board of the importance of internal control, and that the most effective way of doing that is by introducing directives.

#### **4.1.3.3 Company G**

The respondent holds the position of Risk and Financial Controller and has worked at the company since 2007; therefore he was not present when the Code was implemented. He is working with risk management and the risk reporting process at group level, and collects risk reports from business areas, group staffs and country organizations. These risk reports consists of business risks and risks related to the financial reporting. He also coordinates the external audit and evaluates and consolidates figures in the balancing of the books. The respondent is working 50 percent in a division called Group Financial Control. This group does the consolidation of the group of companies, handles the parent company's accounting and manages the reporting process, which requires a lot of quality examination of the reporting. The risk reporting process is a special field within financial reporting. Risks connected to important business areas are distinguished, and internal control routines intersecting the entire group are imposed to manage those risks. Group Assurance, another division who evaluates internal control within the organization, makes sure that the company has effective

procedures.

Since the introduction of the Code the workload has initially increased, but the respondent finds it difficult to distinguish between direct consequences of the Code and consequences of the many other demands that have surfaced in the last couple of years. Rather than coming from the Code, the highest demands for comprehensive information comes from investors, internal and external interested parties, the board, banks et cetera. As the demands on internal and external information have increased, the company has improved its processes and systems, making the long-run workload almost unaffected by the Code.

During the last couple of years it has become more important to have an independent and well-established group assurance division and a well-working risk reporting process, and the company has therefore established these functions.

The company has a long tradition of internal audit, but the last few years have given internal audit a clearer purpose and more independency, which in turn has elucidated the roles of both the internal and external auditors by separating auditing and counseling. The respondent finds it particularly important that the internal auditor is independent. By being independent he can emphasize risks and do risk assessments of his own by looking at risks from another point of view, and he will also not be seen upon as a police when visiting daughter companies within the group.

Over time, the respondent has experienced a growing orderliness, which makes it easier to focus on areas with problems. The problems have not grown bigger during the years, but with better processes in place, it is easier to distinguish them. Though heavier demands initially are hard to live up to, they wake people up and unburdens with time.

Internal control creates value by providing general orderliness. At group level, it is important to be certain that everyone within the organization is acting equally. In order to make correct decisions the company has to be able to trust the quality of the information they receive. One can never assure that everything is one hundred percent accurate, but internal control helps avoiding unpleasant surprises and systematic problems. The respondent does not wish for a more detailed internal control; he believes that it is more important to have a comprehensive external framework that is well implemented. The principle is more vital than the details.

The respondent finds COSO to provide some sort of guidance, but at the same time he is of the opinion that they have taken something fairly simple and turned it more complicated than it has to be. COSO is used to manage risk, and the company's framework for managing risk is partly built on COSO, but adjusted to be intelligible for everyone within the organization. The respondent thinks that one should gather inspiration from different frameworks and tune it in accordance with the organization.

The general attitude towards the Code is positive, and the respondent cannot recall hearing about any problems implementing it. The Code provides an enhanced clarity, and a hint of the expectations. The respondent states that different people will of course

have different opinions about certain lines in the Code, but he believes that in general people are positive towards its implementation.

As far as he knows they comply completely with the Code, and he finds the "comply or explain" principal excellent. The respondent finds it important to report what is relevant and not only to report information that just meets the requirements of the Code. Having compelling rules would have been difficult, because some demands might not fit a certain company, depending on in which field or phase that company is.

The company possesses in-house SOX experience from some employees who have worked with the act earlier, and they are not too enthusiastic about it. Further the respondent does not believe sanctions to be efficient; if a company has to comply with SOX, they are doubtlessly going to fulfill the obligations on papers.

The respondent has no reason to believe that the Code is not sufficient in the eyes of foreign investors. The Code requires some sort of minimum level and since investors seek to minimize their risk-taking, the Code could have an influence on their decision. Though the respondent is convinced that there are many things more important to investors than whether the company complies with the Code or not.

Laws and directives doubtlessly contribute to prevent future scandals, but unfortunately people are too inventive when it comes to frauds and irregularities, and future scandals will occur despite any laws or regulations. The respondent states that the only thing possible to prevent is for the exact same scandal to happen again. The only assurance against scandals is to have a sound management and corporate culture, but unfortunately it is not possible to drive that through by any law or regulation.

When asking the respondent if he wants to change anything about the Code, he would like to see demand for an even greater transparency in reporting identified risks. The company has a common wish for not having to provide a forecast, something the respondent finds totally irrelevant since someone outside the company could calculate that as well.

The respondent would like future internal control to be more active, by not just verifying the controls, but rather actively manage them. The respondent emphasizes that a solid framework and a sound corporate culture is more efficient than detailed rules in the Code, and that the culture is the most important, which is impossible for the Code to impose.

#### **4.1.3.4 Company H**

The respondent worked as an auditor before the introduction of both SOX and the Code. He started working at the company as a business controller, and at that time the Code only applied to larger companies. As of January 1, 2009 the revised Code came into force requiring all Swedish companies registered on the Swedish stock exchange market to comply with it, including this company. Since the respondent had a background as auditor the task of implementing the Code became his responsibility.



When implementing the Code, the company had to start from scratch by making an inventory in which they had everyone fill in a questionnaire that an auditing firm later verified. At the same time they also developed a risk management model with strong influences of COSO. They listed their ten largest risks in every line of business, and analyzed how to manage them. The options were to reduce, eliminate or live with them. They launched workshops moderated by the respondent, where the participants had to discuss risks. All in all, the company has developed a more structured risk management and a better sense of what the risks are.

The initial responses to the internal control improvements were that it was a hard and boring job with no benefits, but the workshops made several participants realize that they were in fact facing fairly big risks, and that they could actually have use for the improvements. Realizing this allowed them to better handle the identified risks and to work on reducing them. Although they had to reserve extra time for working with internal control only a few persons received an increased workload, and the operational activities were not affected at all. When asking the respondent about any particular difficulties in implementing the Code he answers that it was a bit difficult to sort the whole business out and to determine where they were at. It should also not be forgotten that they are just in the beginning stages, and there is still work left to be done.

The operational responsibility for internal control is shared between the respondent and the CFO, whereas the ultimate responsibility lies with the CEO, to whom the respondent reports. The company does not have any internal audit, though the respondent has carried out some of the work. When asking the respondent about COSO he says that it is an excellent framework, although he finds it relatively unclear to someone without an economical background.

Internal control creates additional value primarily by increasing the management's chances to operate effectively. They make use of the internal control when suggesting on improvements, when creating explicit policies and when deliberating on how to proceed with economical reporting. The internal control is also of great use for business programs and risk scenarios within all their lines of business.

To the right extent, the respondent believes a more thorough internal control will contribute positively to the company's business. When running the controls, faults will always be found the first couple of rounds, but when properly handled, the findings will result in improvements, even though it might be difficult for the ones concerned. Further he says that either you implement a bare minimum internal control just because you have to, or you try to make it as useful as possible in order to bring extra value to the company.

The respondent finds that implementing internal control has definitely been worthwhile, and he considers the Code an excellent instrument for doing that. At the time they started implementing the Code, they were in the middle of a merging, which forced them to start running risk analyses more actively; therefore the Code came very conveniently and allowed them to use it to force the pace. Above all, he finds it very positive that people within the organization have come to understand the importance

of internal control.

When asked about how the collaboration between the internal and external auditors has changed, the respondent says it is hard to tell, but the Code has given the external auditors an improved foundation and made it easier to distinguish shortcomings in the corporate governance report.

The company complies with the Code as a whole, and the respondent considers the demands to be on a reasonable level. He finds the "comply or explain" principle sufficient and does not wish for any change in the Code. When further asked if the Code should contain more detailed control rules he answers both yes and no. As already mentioned, he finds the demands of the Code to be on a reasonable level, though he would find it better if the external auditors had to verify the statements about internal control in the financial reports. If that came to happen, the Code would probably need to be a bit more specific in some areas.

The respondent believes that the Code helps protecting the owners' investments and the company's assets, though it will not prevent future scandals. He says that it will be more difficult to commit fraud, since more people has to be involved, but it will still be possible. Further he does not find the SOX-associated sanctions reasonable; he is of the opinion that economical responsibility is enough to prevent malicious intent.

The respondent has no sense of how the Code stands internationally, but he believes that laws and directives are important in the wake of recent scandals. Though complying with the Code shows that companies are working with internal control, it is difficult for the investors to really know what is going on, since many companies will still not report what is not working.

In the future the company will continue their work with internal control and create a desirable behavior to increase the quality of the controls.

## 5 Analysis

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*This chapter contains an analysis of the data presented in the empiric, connected to the information provided in the theoretical framework.*

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It is obvious that recent years have brought many changes to the internal control within companies. Many companies have either implemented new divisions for internal control or improved existing ones. For those who have implemented SOX, the act has clearly been a driving force in creating a more focused internal control and has initially made a tremendous impact on their workload, whereas for those who have implemented the Code, the opinions differ on what the driving force has been. Some companies have not been affected much by the introduction of the Code, since they for the most part already complied with it, whereas some companies have developed a more thorough internal control than the Code demands.

### 5.1 Sarbanes-Oxley Act

There is no doubt that SOX is an expensive business for those companies subject to it (FAR SRS, 2005a). Several companies testify to the tremendous amount of work followed by enormous costs for implementing it, but it seems like those who have worked with SOX for some time, are more positive about it than others. Their general opinion is that SOX brings orderliness, which is in accordance with the observations of Björn Wahlborg (FAR SRS, 2005a). One of the respondents says that once all obstacles are overcome, and the objective are in clear sight, SOX is a well-working set of rules and regulations. Another respondent, who has previously worked with SOX projects as an auditor, has implemented parts of SOX even though his company is only required to comply with the Code. SOX has made it a lot easier to discover financial risks, and given a great advantage for those working at the accountants department, since they now can put greater trust in the figures, one respondent says.

Many companies hired more than one accounting firm and performed a lot of duplicate work, lest they violate the law (FAR SRS, 2005b), and some respondents believe that accounting firms initially made SOX more complicated than it actually was, thus increasing their revenues from consulting and auditing. Expenses for implementing SOX can amount up to over one billion SEK (FAR SRS, 2005b). Despite that, one respondent consider the work with becoming compliant to be a very good investment, and says that it is important to take care of how SOX has changed the work with internal control, but in a simpler and less expensive way; SOX is a bit too complicated and too much auditor-controlled.

SOX has received much criticism for being too extensive (FAR SRS, 2005b), requiring even low-risk areas to be carefully controlled (Beusch 2007, p.141), which several respondents agree with. Two respondents also finds the testing too extensive,

and one of them has cut down on it since leaving SEC, and the other would have done so if possible.

## **5.2 Swedish Code of Corporate Governance**

The intention of the Code is for every company to carefully consider which directives are suitable for their business and only thereafter apply them (Svernlöv 2008, p.44). This does not seem to be the case for most companies. Only one of the interviewed companies has made a deviation from the Code, whereas some of the others do not seem to work much with the Code at all, except from having the external auditors making sure they are compliant with everything. Several companies have established a more thorough internal control than required, without really paying much attention to the Code. One respondent does not believe that the introduction of the Code itself has made it easier to become more aware of financial risks, since they already worked on finding them before. In their annual report of 2008, the Board reported that the Code has reached a considerable acceptance among companies and has essentially been applied as ambitiously and flexible as it was intended to be (Svernlöv 2008, p.291). This might be true, but the Code does not seem to be the driving force for improving the internal control at most companies.

The code is supposed to complement the Swedish Companies Act, by setting a higher level of ambition for corporate governance (Svernlöv 2008, p.38, 40). But the fact that it only briefly treats internal control makes it rather unclear (FAR SRS, 2006). This is supported by several respondents, where one of them finds it hard to make out what the minimum requirements are. Being developed in two stages (Svernlöv 2008, p.19), the Code should be well worked-out. Still, there are several wishes for changes; one respondent would that it contained clearer minimum requirements; another one would that it required companies to follow a certain structure; and a third one would that it required greater disclosure of reporting financial risks; and two respondents would that it required the external auditors to review the board's statement about the internal control, otherwise there are no guaranties that companies really comply with the Code.

The general attitude towards the Code is positive, and most respondents are fond of the "comply or explain" principle. The principle allows for passing on rules that do not match the particular circumstances or the size of the company (Svernlöv 2008, p.41-42). Still, the opinions differ about the principle. Some respondents find it insufficient, as it allows for not complying with rules essential for ensuring sound corporate governance. One of the respondents would that the Code required the external auditors to verify the statements about internal control in the financial reports, in order to ensure the quality, but with the "comply or explain" principle, companies could leave that out, making it impossible to really ensure the quality.

### **5.3 Sarbanes-Oxley Act versus Swedish Code of Corporate Governance**

The Code has emerged from a Swedish tradition of self-regulation (Svernlöv 2008, p.35), and the Board considers self-regulation to be preferred over legislation (Svernlöv 2008, p.26). One respondent shares this view; he finds it problematic with legislations such as SOX, since it is very American and the contrary to the Swedish way of working, which is supported by Anders Hult (FAR SRS, 2005a). Other opinions are that a solid framework and a sound corporate culture are more efficient than any detailed rules, and that it is more important to convince investors, managers, owners and the board of the importance of internal control, and the most effective way of doing that is by introducing directives. A different opinion is that legislation is helpful in making everyone within the company focus on internal control, and thus making it easier to carry through changes in the internal control, though one respondent found the Code to have the same effect. In one of the Code-compliant companies, where the initial responses were that internal control is hard and boring with no benefits, they introduced workshops, which made the participants realize that they were in fact facing fairly big risks and could actually have use for improvements even if no law forced them. One respondent says that he finds laws to be most effective during recession, when no one seems to have time for internal control, and he sees it fit to introduce laws in Europe as well.

The interviews indicate a dislike of the legal sanction SOX carries (107th Congress, 2002). Though the Code lacks legal sanctions, there still is a law, the Swedish Companies Act, consisting of fundamental rules for the organization within companies (Svernlöv 2008, p.51), which one respondent also points out. Most respondents consider sanctions ineffective, and one of them states that bad publicity is far worse than paying fines. In contrast, one respondent finds them reasonable, though he considers it a shame that it should be needed. Another respondent argues that since the sanctions are connected with lying and not with shortcomings, and that frauds affect many people, the sanctions are not unreasonable.

Swedish corporate culture differs from US corporate culture; in Sweden we have tradition of trusting people to perform their task without having to document everything, but in the US that is not the case (FAR SRS, 2005a). Whereas SOX requires all controls to be documented (KPMG, 2009b), the Code does not (Kollegiet, 2009b). Thus, to become SOX compliant, it requires a tremendous amount of work doing all the documentation, which several respondents witness to, and view as one of the most negative aspects of SOX.

One argument for introducing a SOX based system, even though not required to, was to save money on external auditing, which is very expensive. The idea is to make sure that the financial risks viewed by the company are in accordance with those of the external auditors, and to provide documentation of how they face those risks with both detective and preventive methods; hence they can save a lot of money on external auditors, since the auditors only has to do a re-performance of the work already done.

The respondents describes the implementation of SOX as large costly projects which has affected everyone and increased the workload substantially. Implementing the Code, on the other hand, seems to be a more slow-progressing work. Many companies had already started improving the internal control, and the Code rather became a part of that process than being the core of it.

## **5.4 Internal Control in General**

General opinions on internal control is that it provides orderliness, helps identifying financial risks and ineffective transaction flows, creates a common view and increases the awareness, lowers the external audit fees, ensures correct figures, creates a better process thinking, gives a quality label and helps when suggesting on improvements, creating explicit policies and deliberating on how to proceed with economical reporting. These opinions agree well with the purpose of COSO framework(Svernlöv 2008, p.149), and several of the companies have strong influences of the framework in their internal control system.

All respondents agree with (Green 2004, p.XI), that scandals will not be prevented by any law or directive, though several respondents believe that it will be more difficult to commit fraud, since with greater disclosure it needs to involve more people. One respondent says that the companies must have a desire for creating a sound corporate culture, only that will prevent fraud. The majority of the respondents believe that internal control rules contribute to protect owners' investments and companies' assets. Though one respondent does not believe that the Code itself protects but rather how the companies choose to implement their internal control. This view is partly shared by another respondent saying that by focusing on internal control the company's assets are being protected, but if the management were to plan for irregularities the laws and directives would not do any good.

Many respondents believe there will be more co-ordination and internationalization of the internal control directives within the European Union, and there is already a cooperation started between the Nordic countries (Kollegiet, 2009d). The opinions differ in whether the self-regulations will remain or if there will be legislation, though most of them prefer self-regulation.

## 6 Conclusions

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*This chapter concludes the analysis and tries to answer the question raised in the problem statement. In addition, suggestions on future studies are given.*

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*Out of Swedish companies' perspective, what is most effective, self-regulation, with the possibility to either comply or give an explanation, or detailed regulation by law?*

The Code appears to better match the Swedish culture than SOX, which is too American and too extensive. Still, the Code does not seem to make much difference; several companies work on improving their internal control without really looking at the Code, and some were more or less compliant before the introduction of it.

As it looks today, SOX is much more effective in making the companies improve the internal control, as the companies which had to comply with it were driven by it and made huge changes, whereas the companies which had to comply with the Code were neither driven by it nor much affected by it. Though the interviewed companies all seem to care for a sound internal control, and are actively working with it, that might not be the case for all companies. This does not mean that a law is more effective than self-regulation; the Code could be improved in several areas. To be more useful for companies, the interviewed companies would that it contained more specific guidelines and an overall better framework, but still left the details for the companies to design. It should also require the external auditors to verify the statements about internal control in the financial reports, in order to ensure the quality. There are different opinions on whether the "comply or explain" principle should be kept or not, though most seem to find it excellent. Since some rules might not fit all organizations, a better solution that would agree with most respondents' view, would be to keep the principle, but forbid deviation from rules that are essential to ensure sound corporate governance.

Since the Swedish Companies Act already includes basic laws for the organization within companies, there is no reason to abandon self-regulation. Swedish companies strive for complying with the Code and do not wish for bad publicity. If only the Code were changed as described above, it would be much more effective in ensuring a sound corporate governance, and thus better protect the owners investments and the company's assets, and still not cost as much or require as unnecessarily detailed controls in low-risk areas as SOX do. With clearer guidelines, the Code could also better help reducing the external audit costs, by providing a better foundation for the external auditors. None of the respondents believes that any law will prevent fraud. The companies must have a desire for creating a sound corporate culture, only that will prevent fraud. Therefore, the directive should be formed to provide the best possible help in improving the internal control, and that is not made easier by abandoning self-regulation for a law.

## **6.1 Suggestions on Future Studies**

It would be interesting to study what view the accounting firms have on the topic. Furthermore it would also be interesting to interview other employees within the organizations, to learn what changes they have observed. Finally, it would be interesting to investigate if companies have a different view on internal control in a few years from now.



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## **Appendix A Interview Template**

Tell us a bit more about yourself, what position you hold, what your assignments are et cetera.

How is the internal control organized?

With whom lies the responsibility?

How is the internal control inspected?

What does the report process look like?

How is the internal control followed up, and what evaluations are performed?

What value does the internal control create in your opinion?

Do you sense that demands on a more thorough internal control positively contribute to the business and the management of it?

How do you work with the frameworks and directives?

In what way have the routines changed since the introduction of SOX and the Code?

In what way have the assignments and the workload been affected?

Has the way of inspecting, following up and evaluating the internal control changed?

Has it become easier to discover and become more aware of financial risks within the businesses?

Are you working with the COSO framework?

How have you found the adaption to the Code or SOX?

What has been difficult?

Was it worth it, looking at the result?

Do you consider the Code or SOX to have improved the internal control?

What is your general attitude towards SOX, and has your opinion changed over time?

In what way has the relation between the internal and external auditors changed?

Do you look anything at SOX, even though you are not bound to comply with it?

Do you comply with the Code as a whole?

If not, what deviations do you make, and why?

Is the "comply or explain" principle sufficient for the internal control?

Would you like to see any changes?

Do you consider the Code in need of more details for the internal control?

If so, in what way?

What is the foreign investors view on the Code in comparison with SOX?

Did SOX contribute to unregistering with SEC?

Have you kept any parts of SOX?

If so, which parts and why?

What are the positive or negative consequences of complying with SOX, and which is the dominant side?

Would you avoid any part of SOX if they were voluntary?

Would you have implemented any parts of SOX, even if you did not have to?

What is your opinion about the heavy sanctions associated with SOX?

Do you consider SOX and the Code important for increasing the trustworthiness of companies?

Do you believe that rules for internal control helps protecting the owners' investments and the company's assets?

Do you believe that SOX and the Code helps preventing future scandals?

Have you received any positive feedback from the owners for complying with SOX or the Code?

Do you sense that your trustworthiness has increased?

How do you look at the future development of internal control?

## **Appendix B An Outline of SOX and the Code**

### **Sarbanes-Oxley Act**

The Sarbanes-Oxley Act is arranged in eleven titles with numbered sections and sub-sections. The first title treats PCAOB, how they are appointed, their authority and so on. (Moeller 2004, p.12-13) The second title sets up new rules for external auditor independence (Moeller 2004, p.34). The third title treats corporate responsibility including demands for an audit committee. The fourth title imposes an enhanced financial disclosure (Moeller 2004, p.43). The fifth title is designed to resolve some securities analysts abuses (Moeller 2004, p.53). The sixth and the seventh title covers a series of issues ranging from the funding authorizations of SEC appropriations to plans for future studies (Moeller 2004, p.53). The eighth title includes specific rules and penalties for the destruction of corporate audit records and requires a whistleblower protection (Moeller 2004, p.55). The ninth title contains penalty enhancements for white-collar crimes (Moeller 2004, p.56). The tenth handles the signing of corporate tax returns (107th Congress, 2002). The last title, the eleventh, defines overall corporate responsibility for fraudulent financial reporting. This title authorizes SEC to freeze the transfer of corporate funds to individuals within companies under investigation (Moeller 2004, p.57).

### **Swedish Code of Corporate Governance**

The Swedish Code of Corporate Governance is divided into eleven sections: 1 The shareholders' meeting; 2 Appointment and remuneration of the board and auditors; 3 The tasks of the board of directors; 4 The size and composition of the board; 5 The tasks of directors; 6 The chair of the board; 7 Board procedures; 8 Evaluation of the board of directors and the chief executive officer; 9 Executive management remuneration; 10 The audit committee, financial reporting and internal controls; and 11 Information on Corporate Governance. (Kollegiet, 2009b)