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The Audit Committee Information Sources: A Disadvantage of the Two-tier System

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Abstract: There are two leading corporate governance systems established in the world today: a one-tier and a two-tier system. Distinctions between the two systems are decreasing, with audit committee being one of convergence factors. Nevertheless, legal status of audit committee in a two-tier system is still not fully comparable to its legal status in a one-tier system. One of the differences that remain even after the most recent reform of the EU audit law relates to the possibility of obtaining information, and high-quality information is one of essential conditions for effective functioning of audit committee. The dilemma is whether the audit committee has an option to obtain information directly from the company's employees. In this respect, the question of possible direct communication between the audit committee and internal auditor is central to the discussion. This issue is specific to the two-tier system. According to prevailing opinions in theory of the two-tier system, this possibility of direct communication is allowed only in exceptional cases. However, this strict approach is slowly weakening, which is especially true for the banking sector. The interaction between the audit committee, the auditor of annual reports and internal auditor is one of the indicators of good corporate governance.

Key words: audit committee; corporate governance; information sources; internal auditor; two-tier system
JEL code: K12

1. Introduction

There are two leading corporate governance systems: a one-tier and a two-tier system. The first model, i.e., the one-tier model, which is characterized by having only one body-the Board of directors that is responsible for both management and supervision — a Unitary Board, is much more common worldwide. In a two-tier system, functions of management and supervision are strictly separated and divided into two bodies: the Management board and the Supervisory board — a Dual Board. Members of the Management board cannot be members of the Supervisory board.

Every corporate governance system has its advantages and disadvantages. The main disadvantage of the one-tier system is execution of supervision, since it requires members of the body to supervise themselves. This disadvantage is eliminated when the majority of members of the body consists of non-executive directors, and by forming the audit committee, whose members cannot be executive directors. The Board of directors is thus *de*

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facto divided into two parts. All members of the body-including non-executive directors, who assume performance of supervisory functions — nevertheless remain responsible for management of the company. Involvement of non-executive directors in management facilitates better information flow between both groups of members, while it also provides a possibility for non-executive directors to obtain additional information, not only from executive directors, but from any person in the company. Universal competence of the Board of directors to manage the company includes the possibility to obtain any information. In case certain tasks are delegated to the committee, for example, the audit committee, necessary competencies are generally transferred as well. Information sources of non-executive directors are unlimited-non-executive directors have access to the same information sources as executive directors.

The availability of information sources needed to carry out supervisory function is the main weakness of the two-tier system. The main information source of the Supervisory board are management reports-possibilities of direct access to other information sources are limited. This means that information is mostly provided by those subjects, whose work is supervised by the Supervisory board. This of course creates a risk of conflict of interest and thereby of increased information asymmetry.

Even though a trend of convergence can be detected, differences between the two governance systems remain significant. This divergence is also evident in the case of the audit committee. The audit committee is an idea that derives from the one-tier system, and already has a long history. In the context of discussions on improvement of corporate governance, which followed in the aftermath of major financial scandals both in the US and in Europe *(Enron, WorldCom, Parmalat, ...)*, this idea also spread to legal environments that are characterized by the two-tier system. *Sarbanas-Oxley Act* (SOA-USA, 2002) has had a major impact on national codes of corporate governance, as well as on legislative activities of the European Union (EU) institutions.

The existence of the audit committee is now a standard of corporate governance, not only for public companies with the one-tier system, but also for public companies with the two-tier system. However, the integration of “Anglo-American” audit committee into the two-tier system faces certain obstacles, due to which it does not have the same power as in the one-tier system. These obstacles are a reflection of a fundamental structural difference between the one-tier and the two-tier system: in the one-tier system, functions of management and supervision are combined in the Board of Directors, while in the two-tier system, these two functions are strictly separated and divided into two bodies. In the one-tier system, the audit committee can obtain information directly from the internal auditor, while in the two-tier system, this is permissible only in exceptional cases (*see below*).

The internal auditor has potential to be one of the most important sources of information for the audit committee not only in the one-tier system but also in the two-tier system. According to the definition by the Institute of Internal Auditors (USA), internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. On the other hand, a function of the internal audit is — among others — overseeing the financial reporting and monitoring the effectiveness of the company’s internal control, internal audit and risk management systems. This means that a close link exists between tasks of the audit committee and functioning of the internal audit: the audit committee supervises efficiency of the internal audit, while internal audit reports can also be grounds for evaluation of efficiency of internal controls and risk management system by the audit committee.

The internal audit represents "eyes and ears" of the Board of directors or the audit committee. The importance of the internal audit for Corporate Governance-System can be best illustrated with the following statement by the Chairman of Board of directors in one of the companies with a one-tier system: *The relationship to the Internal Audit is the most crucial as the Board is mostly isolated. That is why turning to the Internal Auditors, you know the hot issues and you are informed what is going on* (Sawyer, 1996, p. 24).

A study on directors' obligations and liability, which was commissioned by the European Commission (EC) and conducted by *London School of Economics* (April 2013), shows that a number of Member States that allow a choice between the one-tier and the two-tier system (the so-called optional model) is increasing in the European Union. These Member States are: Bulgaria, Denmark, Finland, Croatia, France, Hungary, Italy, Lithuania, Luxembourg, Portugal, Romania, Slovenia and with some restrictions also the Netherlands. Nevertheless, in many Member States, the choice is still not an option. Thus, only the two-tier system is allowed in Germany, Austria, Czech Republic, Estonia, Latvia, Poland and Slovakia, while the one-tier system is a forced model of governance in the UK, Belgium, Spain, Ireland, Greece, Malta, Cyprus and Sweden. However, even in Member States that recognize the option of choice, the one-tier system is more common.

The two-tier system is a German "invention", and is in Germany the only admissible model of governance of "national" public limited companies. Other member states that have enacted the two-tier system have followed the example of this law. Therefore, this contribution is based on a brief analysis of German law. German law is then compared with the latest developments in Slovenia, which is one of the countries with optional model, but the two-tier system is much more widespread in practice. In Slovenia, a comprehensive reform of corporate law was conducted last year (amendments to the Companies Act (*Zakon o gospodarskih družbah*) — ZGD-1I, Official Gazette of RS, No. 55/2015). In this context — among other things — provisions regulating the audit committee were amended, mainly due to the implementation of Directive 2014/56/EU, and some aspects of direct cooperation between the Supervisory board and the internal auditor were enacted. The aim was to strengthen the position of the internal auditor and to improve the efficiency of the Supervisory board.

2. The Audit Committee after the Latest Reform of European Audit Law (Directive 2014/56/EU)

On 16 April 2014, a comprehensive Directive 2014/56/EU was adopted, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. Among other things, the directive affected provisions regulating the audit committee of the Supervisory board or the Board of directors, but without any significant changes. Conceptual differences between the audit committee in the one-tier system and the audit committee in the two-tier system therefore remain even after the latest reform.

The directive has extended and partly complemented tasks of the audit committee (Article 39, item 6). One of its central tasks is to monitor the processes of financial reporting and the effectiveness of internal controls, risk management systems and internal audit, namely in relation to financial reporting. Directive additionally provided that the audit committee shall make recommendations and proposals to ensure the integrity of financial reporting. The second set of functions relates to the audit of financial reports: the audit committee monitors statutory audit and reviews and monitors independence of statutory auditors or audit firms. Two additional tasks were added to this set of functions. The audit committee is responsible for the procedure for selection of statutory auditors or audit firms, and it also informs the Board of directors or the Supervisory board of the outcome of the statutory audit and explains how the statutory audit contributed to the integrity of financial reporting and what the role of the audit committee was in that process.

All public-interest entities should have an audit committee, but the directive allows the Supervisory board to refrain from establishing the audit committee and to perform all the tasks itself. In fact, the option of a Member State, which enacted the two-tier system, to refrain from prescribing a mandatory audit committee already existed under the previous regime and was only confirmed by the latest directive. However, in case the audit committee was established, the directive requires a majority of its members to be independent from the audited entity, including the chairman of the audit committee. Nevertheless, Member States may also waive this requirement. If all members of the audit committee are members of the Supervisory board or the Board of directors, it is not necessary for a majority of them to be independent (Article 39, item 5). As regards the qualifications, the directive has retained a requirement that at least one member of the audit committee shall have competence in accounting or auditing (Article 39, item 1). New is a provision that all members of audit committee shall have competence relevant to the sector in which the audited entity is operating.

A comparison between Germany and Slovenia shows that Germany chose both options, while Slovenia chose none. Under German law, the audit committee is already not mandatory. In Germany, it is estimated that the enactment of mandatory audit committee is not needed, since the vast majority of major public companies already has an audit committee, which is a consequence partly of Anglo-American influence, partly of recommendation *of Deutsche Corporate Governance Kodeks* (Recommendation No. 5.3.2), and the establishment of audit committees in medium-sized or small companies would not be rational (Merkt, 2015, p. 613). In case the company has an audit committee, German *Aktiengesetz* (AktG) does not further require that a majority of members shall be independent from the company. In Slovenia, the audit committee is compulsory for all public-interest entities.[1] At least one member must be an independent expert and qualified for accounting or auditing — the same applies in German law (the fourth paragraph of par. 107 in connection with the fifth paragraph of par. 100 AktG). The other members of the audit committee may only be members of the Supervisory board, who are independent from the audited entity (first paragraph of Article 280 of ZGD-1). This means that Slovenia set even stricter requirements concerning independence of audit committee members from those required by the European directive.

As regards responsibilities of the audit committee, Germany is not planning any significant changes or additions other than those which are necessary for compliance with European law. Slovenia has already harmonised a renewed definition of the audit committee's functions from Directive 2014/56/EU with the amendment ZGD-1I (the third paragraph of Article 280), with the list of tasks of the audit committee being further extended. In this respect, the most important is a new task of the audit committee, pertaining to which the audit committee cooperates not only with the auditor of annual and consolidated report, but also with the internal auditor, in particular by exchanging information on major issues related to the internal audit. A new Article 281.a of ZGD-1 also refers to the internal audit. In accordance with this Article, the annual report on internal audit shall be submitted to the Management board, the Supervisory board and the auditor of financial reports. The Supervisory board may ask the internal auditor to provide additional information — if a company has an audit committee, this right shall be exercised by the audit committee. The Supervisory board is responsible for giving consent to appointment, dismissal and income of the head of the internal audit, to the act that governs the function, purpose and responsibilities of the internal audit and to the internal audit plans.

[1] Public-interest entities are companies with securities traded in the regulated market, as well as banks and insurance companies.

Numerous researchers of corporate governance consider a relationship between the audit committee and the internal auditor “symbiotic” (Abbot, Parker & Peters, 2010, p. 4). An effective audit committee increases the quality of the internal audit and vice versa: an objective internal audit supports the audit committee in prevention of errors in financial reports. The condition for this is independence of the audit committee from the management. The auditor of annual financial reports may also refer to results of the internal audit — under the conditions laid down in the International Standards on Auditing (ISA 610). Therefore, an effective internal audit may also contribute to greater efficiency of auditing of annual financial reports, which is carried out by the external auditor. Mutual cooperation between the audit committee, internal and external auditor thus improves and rationalises the processes of supervision and thereby improves the quality of system of corporate governance.

3. Problem of Information Asymmetry and Conflict of Interest in the Two-tier System. “Information Monopoly” of the Management Board and Restricted Possibilities of Obtaining Independent Information

In the two-tier system, which is characterized by institutional separation of functions of management and supervision, and by their distribution between two different bodies, the Management board and the Supervisory board, two fundamental problems can be identified. The first problem is information asymmetry: since the Supervisory board is excluded from business management, it is also excluded from information sources. Solving this problem leads to the second issue: to conflict of interest. The main source of information for the Supervisory board is the Management board.

The Management board is responsible for business management and thus has the best access to the information needed by the Supervisory board in order to exercise supervision function (cheapest cost avoider). Thus, both German (the first paragraph of par.90 AktG) and Slovenian law (the first paragraph of Article 272 of ZGD-1) list issues on which the Management board shall periodically report to the Supervisory board (the so-called pushprinciple). The Management board shall, for example, report regularly on: the planned business policy and other fundamental issues of corporate planning, transactions which may have a significant impact on economic viability of the company and on its liquidity, etc.

In addition to regular reports, the Supervisory Board may request additional reports from the Management board (the so-called pullprinciple) — information duties of the Management board towards the Supervisory board and its committees are unlimited. Nevertheless, the Management board is the one being supervised and have its work evaluated by the Supervisory board. The Management board tends to emphasise favourable information before the Supervisory board and to withhold information it considers unfavourable (Seibt, 2009, p. 392). In short, there is a risk of conflict of interest with management reports and thereby of incorrect or incomplete information, whereas high-quality and timely information is an essential condition for the effective exercise of supervision.

It is therefore important to have additional resources available — the information independent from Management board, which allows for verification of management reports and substitution of its incomplete or incorrect reports (Leyens, 2006, p. 160). Since in the one-tier system the Board of directors is responsible both for management and supervision, non-executive directors are able to access the same information sources when exercising supervisory function as executive directors. In the two-tier system, possibilities of the Supervisory board, and therefore also of members of its audit committee, to obtain information independent of the Management board are limited. The most important external source of information is the auditor of annual financial reports, who is appointed by the assembly upon proposal by the Supervisory board. The Supervisory board also enters into contract with the external auditor and thus has the opportunity to influence determination of the focus of auditing, etc. Furthermore, the Supervisory board has the so-called right of access to incorporated information (the second paragraph of par.111 AktG and the second paragraph of Article 281 of ZGD-1). Nevertheless, there are different views in theory and in German case law on whether the Supervisory board may use this right at any time, or only as *ultima ratio* (e.g., overview of opinions in: Drygala, 2015, p. 1726). Both AktG and ZGD-1 provide for the possibility of the Supervisory board to engage the external expert for consideration of specific issues (e.g., tax advisor, external auditor, etc.).

The key dilemma is whether the Supervisory board may obtain information directly from employees or, for example, from members of management bodies in controlled companies, of which there are different views as well. In this respect, a prevailing opinion remains that direct contacts with “lower levels” are only permitted with consent of the Management board, unless in case of suspicion of serious irregularities by the Management board, or if the company is in crisis (e.g., overview of opinions in: Leyens, 2006, p. 183; Lutter & Krieger, 2008, p. 106; Velte, 2011, p. 1402; Velte & Eulerich, 2013, p. 126; Dittmar, 2014, p. 212; Drygala, 2015, p. 1697). This opinion is supported by various arguments. Obtaining information directly from the employees would mean interference with business management, which is the responsibility of the Management Board and from which the Supervisory Board is excluded. That would violate the principle of separation of functions of management and supervision, upon which the two-tier system of management is based. Furthermore, this way of obtaining information — i.e., obtaining information from “lower levels” in the company independently of the Management Board or without its knowledge — would undermine the authority of the Management Board and jeopardize cooperation between the Management Board and the Supervisory Board, which has to be based on mutual trust.

4. The Internal Auditor as an Information Source. Direct Cooperation between the Audit Committee and the Internal Auditor

As a consequence of the above-described positions in German legal theory, a direct access of the audit committee to the internal auditor is permitted only with consent of the Management board. The consent is not necessary if there is a suspicion of serious irregularities by the Management board, or if the company is showing signs of the crisis. Such restrictions do not exist in the one-tier system: the audit committee has a possibility of direct access to the internal auditor, regardless of the suspicion of serious irregularities and irrespective of the consent of executive directors. In the one-tier system, the internal auditor is functionally subordinate to the audit committee. Because of separation of functions of management and supervision in the two-tier system, functional subordination of the internal auditor to the Supervisory board is unacceptable (Hucke & Münzenberg, 2015, p. 132).

A possible solution for improvement of cooperation between the audit committee and the internal auditor in the two-tier system is an advance agreement between the Supervisory board and the Management board. The information policy of the Management board or the rules of procedure of the internal audit may determine, for example, the following issues: submission of internal audit reports directly to the Supervisory board, participation of the internal auditor at meetings of the Supervisory board and the audit committee, and the *ad hoc* information duty of the internal auditor towards the audit committee (e.g., in case of suspicion of serious irregularities by members of the Management board, etc., Warncke, 2008, p. 634). The company statute may determine authorisation of the Supervisory board to give consent to the internal audit plan, to appointment and dismissal of the head of the internal audit, to the budget of the internal audit and to its organizational position within the company (Warncke, 2008, p. 636; Velte & Eulerich, 2013, p. 127; Geiersbach, 2010, p. 400). The Supervisory board has the right to determine by itself which issues will require its consent (the fourth paragraph of par.111 AktG; the fifth paragraph of Article 280 of ZGD-1).

Institutionalization of the relationship thus mainly depends on the initiative of the Supervisory board. If it requires participation of the Management board (e.g., in determining that annual internal audit reports are also submitted to the Supervisory board; in stipulation of *ad hoc* information duties of the internal auditor; or in regulation of participation of the internal auditor in meetings of the Supervisory board or the audit committee), the Management board probably will not resist, as it will want to avoid a conflict with the Supervisory board. Eulerich (2012, p. 294) lists the fact that in Germany, about 35% of internal auditors are annually reporting to the Supervisory Board. Internal auditors at least occasionally participate in meetings of the Supervisory board or the audit committee. However, internal audit plans are approved by the Supervisory board in less than 15% of cases.

It can be concluded that cooperation between the internal auditor and the Supervisory board (audit committee) remains weak. However, Eulerich (2012, p. 292) emphasises that the situation in Germany is slowly improving and that the internal auditor, who is in the two-tier system subordinate to the Management board, is becoming an important source of information for the Supervisory Board and its audit committee. The position that a direct access of the audit committee to the internal auditor is permitted only with consent of the Management board, unless there is a suspicion of serious irregularities by the Management board, is currently being “softened”, especially in regulated sectors, for example in the area of banking. The ninth paragraph of Article 25.d of German Banking Act (*Gesetz über Kreditwesen — KWG)* provides that the president of the audit committee may obtain information directly from the head of the internal audit. Notification of the Management board is sufficient.

Slovenia adopted a more “radical” solution and has extended a possibility of the audit committee to obtain information directly from the internal auditor to all companies (Article 281.a of ZGD-1). A position of the internal auditor is further strengthened by authority of the Supervisory board to give consent to appointment, remuneration and dismissal of the head of the internal audit. The Supervisory board also gives consent to annual and multiannual internal audit plans and to the act that regulates function, purpose and responsibilities of the internal audit. Annual report on the work performed by the internal audit shall be submitted to the Management board, the Supervisory board and the auditor of financial statements no later than within 3 months after the end of the financial year. It is a responsibility of the Audit Committee to cooperate with the internal auditor.

5. Internal Auditing and Top Management Fraud

One of the essential and also most difficult tasks of the internal audit is fraud prevention and fraud detection in the company (Peemöller, 2008, p. 6), including various forms of accounting frauds defined in detail in international auditing standards (standard No. 240), to which a special attention must be paid. Frauds can jeopardize not only the achievement of the targets but also the mere existence of the company. This was brought to the attention also by large financial scandals in the last two decades that led to the collapse of numerous companies in the USA as well as in Europe.

The possibilities of the external auditor in this respect are limited, mainly due to the relatively short time available for annual report auditing. But in contrary to the external auditor, the internal auditor works in the company permanently and also has the required special knowledge, in particular as regards the necessary preventive measures. Moreover, it shall also be taken into account that the risk of frauds does not exist only in the field of financial reporting but also in other business areas. Nowadays, the internal auditor is explicitly expected to recognize the signs of such actions in due time, to propose the necessary measures for their prevention and limitation of harmful effects as well as to conduct adequate inspections if such actions already occurred (Hoffmann, 2008, p. 680). Perpetrators can be employees *(Employee Fraud)* as well as Management *(Top-Management Fraud).*

There are no specific problems in the first case as the Management is interested in detecting or preventing such actions. But the picture is totally different if the Management Board is involved in frauds and these very frauds can have much more serious consequences for the company as the employee frauds. Overall powers enable the Management Board to also elude or annul internal controls (the so-called Ma*nagement Override of Controls)* or to "take advantage" of its subjected workers for achieving its own goals (Hoffmann, 2008, p. 681). The effectiveness of operation of internal auditor in such case can be extremely doubtful if he is entirely subjected to the Management Board.

Therefore, it is of crucial importance to grant the internal auditor certain independence vis-à-vis Management Board as far as this is possible in the two-tier system (Podgorelec & Kolar, 2013, p. 151). This independence can be achieved through direct communication between the internal auditor and the Supervisory Board or the audit committee, and with the Supervisory board's consent to essential questions of internal audit (e.g., consent to the internal audit plans and to remuneration and dismissal of the head of the internal audit).

6. Conclusions

Conceptual differences between the audit committee in the one-tier system and the audit committee in the two-tier system remain even after the most recent reform of the EU audit law. One of these differences also refers to the information sources. In the one-tier system, the possibilities of non-executive directors to gain information are unlimited, while in the two-tier system, the main information sources of the Supervisory board members — and thus also of its audit committee — are management reports. This creates a risk of conflict of interest and increases information asymmetry. As a correction of "information monopoly" of the Management board, the right of access to incorporated information is provided by law. In exercising this right, the Supervisory board or the audit committee can be assisted by the external expert. An independent source of information is also the auditor of annual financial reports. Experiences with the one-tier system, however, indicate that one of the key information sources of audit committee is the internal auditor. In this respect, the prevailing opinion in the two-tier system still remains that the audit committee does not have a possibility of direct access to the internal auditor, except in rare cases (e.g., suspicion of serious irregularities by Management board) or if authorized by the Management board.

A comparison between Germany and Slovenia was conducted in this article. The two-tier system is a German "invention", and is in Germany the only admissible model of governance of "national" public limited companies. Slovenia is one of the countries with optional model, but the two-tier system is much more widespread in practice In Germany, a direct communication between the audit committee and the internal auditor is only legally regulated in the field of banking. Slovenia, however, took a step forward with the recently adopted amendments ZGD-1I, and has extended the possibility of direct communication between the internal auditor and the audit committee to all companies. Additionally, the status of the internal auditor is enhanced by the Supervisory board's consent to essential questions of internal audit (organizational position, plans, appointment, remuneration and dismissal of the head of the internal audit). An effective audit committee increases the quality of internal audit and vice versa: an objective internal audit supports the audit committee in performance of its tasks. An efficient internal audit may also contribute to a more effective audit of financial reports.

With tight cooperation between the audit committee and the internal and external auditors, supervision, and with it the quality of corporate governance, is improving and rationalising at the same time.

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