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Corporate Governance in Italy The Collegio Sindacale

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1. INTRODUCTION

The financial crisis that has swept the world economy has shown, amongst other things, the weakness and inefficiency of the current governance systems, based strictly on external intervention mechanisms compared to corporate governance.

We do not wish to *ex ante* define the traditional Italian corporate *governance* model, based on the contraposition between Board of Directors and Collegio Sindacale, as the best model, but it is certainly possible to *ex ante* sustain that this model – being more strict – offers obvious advantages. In fact, this direction and control system guarantees a clear division of roles: direction and control are two separate activities, the General Assembly elects the direction and the control bodies separately, and the independence requirements are disciplined by clear and precise rules.

A study conducted by CNDCEC, “Analysis of company bankruptcies by legal form and the role of the Collegio Sindacale”, shows that the mandatory Collegio Sindacale has significantly reduced the risk of insolvency and has contributed to the qualitative, organizational and production growth of the business entities that constitute most of Italy’s economic fabric. In particular, the study shows that the S.p.A.s (Joint stock Companies) have a lower rate of bankruptcy compared to S.r.l.s (Limited Liability Companies) and that S.r.l.s with an internal Collegio Sindacale have experienced a lower bankruptcy rate versus that of S.r.l.s that do not have an internal Collegio Sindacale. In particular, in the 2002-2006 period, the bankruptcy rate of S.p.A.s was equal to 3.77 per thousand and the bankruptcy rate of S.r.l.s with an internal Collegio Sindacale was equal to 4.27 per mille, compared to a bankruptcy rate of S.r.l.s without a Collegio Sindacale equal to 6.44 per mille, and an overall bankruptcy rate of S.r.l.s of 6.34 per mille.

In other words, this means that the incidence of bankruptcies in companies having an internal Collegio Sindacale is at least 1/3 lower compared to companies that do not have a supervisory body.

Furthermore, it is important to highlight that as regards the so-called “private” S.p.A.s, the option to confer internal control and auditing powers on the Collegio Sindacale is a freely exercisable choice, which companies increasingly often opt for. The data gathered by Unioncamere-Infocamere, referred to January 2009, show that 81% of S.p.A.s entrust an internal Collegio Sindacale with auditing functions and that less than 19% of them appoint an external auditor. As regards S.r.l.s that are required to have a statutory audit carried out on their accounts, only a little more than 10% of them appoint an external auditor.



2. WHAT IT IS AND WHAT IT DOES

The Collegio Sindacale is a body within the company's governance system in charge – primarily – of the control of legality and legitimacy of the direction. Its oversight function is performed on an on-going basis, concomitant to the company's management.

More specifically, pursuant to art. 2403 of the Italian Civil Code, the Collegio Sindacale oversees the following:

- compliance with the law and with the company by-laws;
- respect of the principles of correct administration;
- adequacy of the organizational, administrative and accounting systems of the company and its actual functioning.

The *compliance oversight* function consists in overseeing the enforcement and general respect of the legal and regulatory provisions in force, as well as of any other covenant contained in the company by-laws.

Such oversight function, therefore, consists in verifying the compliance of the transactions and the resolutions made by the corporate bodies with the law.

In fact, in the exercise of its activities, the Collegio Sindacale is responsible for overseeing the respect of the company by-laws and of the legal and regulatory provisions governing the functioning of the corporate bodies and the company relations with the institutional bodies.

The function related to the oversight of the *observance of the principles of correct administration* consists in verifying the compliance of the company Directors' decisions with the general criteria of economic rationality established by the science of corporate economics, without ever examining the managerial appropriateness of the decision.

The Collegio Sindacale oversees that Directors exercise the necessary diligence in the performance of their duties. Oversight of the Directors' diligent behaviour does not consist in a control upon the merit of the appropriateness and suitability of the Directors' economic decisions, but rather in the examination of the aspects of legitimacy of those decisions and in the verification of the Directors' decision-making process.



By way of example, the Members of Collegio Sindacale are required, in overseeing the observance of the principles of correct administration, to ascertain that the Directors do not carry out any transactions which:

- are outside the company's objects;
- are aimed at suppressing or modifying the rights conferred by law or by the company by-laws onto each single shareholder;
- are in conflict with the resolutions passed by the shareholders' meeting or by the Board of Directors;
- are manifestly imprudent or risky;
- may compromise the integrity of the company's assets or pose a threat to the ability of the company to operate as a going concern.

The function related to the *oversight of the adequacy of the organizational, administrative and accounting systems* of the company and of its actual functioning entails the need to verify that the organizational, administrative and accounting systems (understood as the whole of directives and procedures adopted by the company in order to ensure that it conducts its business in an efficient, orderly and transparent manner) are adequate for the nature and for the size of the company, as well as for the type of business activity carried out and for its shareholding structure.

As far as the organizational structure is concerned, the Collegio Sindacale of S.p.A.s listed on regulated markets is explicitly required to oversee also the adequacy of the internal audit system (art. 149, letter c) T.u.i.f). The latter expresses the whole of the directives and procedures that regulate the correct achievement of the company objectives.



3. APPOINTMENT, SUBSTITUTION AND TERMINATION

The Collegio Sindacale is composed of from three to five regular members and two alternate members (art. 2397 of the Italian Civil Code).

The members of Collegio Sindacale – who may be shareholders or non-shareholders – are appointed by the shareholders’ meeting.

With regards to listed companies, the law only provides that the number of members is not less than three and that at least one member (or two if the Collegio Sindacale is composed of more than five members) is appointed by the minority (art. 148 T.u.i.f.).

The chairman of the Collegio Sindacale is appointed by the shareholders’ meeting (and as to listed companies, from among the auditors elected by the minority). The chairman is in charge of managing, coordinating and promoting the Collegio Sindacale’s activities.

In order to protect the independence of the auditors (i.e. the members of collegio sindacale) vis-à-vis the majority of shareholders, as well as to ensure a certain continuity of audit activities, art. 2400 of the Italian Civil Code provides that auditors:

- shall remain in office for three periods (and the company by-laws cannot modify such duration);
- shall expire at the closing of the ordinary general meeting of the shareholders for approval of the balance sheet related to the third period of their term of office;
- shall definitively expire only starting from the time the Collegio Sindacale has been re-established (so-called principle of *prorogation*).

Furthermore, in order to emphasize the independence of auditors and the stability of their appointment, the legislator established a principle of relative irrevocability of the members of the Collegio Sindacale by virtue of which the appointment of auditors may be revoked only for just cause and through the resolution of the shareholders’ meeting subject to approval by the court in order to become effective (art. 2400, second paragraph, of the Italian Civil Code). A typical instance of “just cause” for revocation, as according to the legal principles and to case-law, is the non-fulfillment of the duties inherent to the appointment of auditor.

In case of death, waiver or resignation of a regular auditor, the alternate members shall automatically take his place according to the modalities provided for by the law, and shall remain in office until the subsequent shareholders’ meeting is held which shall confirm their appointment or upon the appointment



of new members to complete the Collegio Sindacale. The newly-appointed members shall expire together with those already in office (art. 2401 of the Italian Civil Code).

Publication of the appointment, expiry and substitution of auditors is carried out by means of registering the latter in the Company register.

The Auditors' annual fees are established, by the company by-laws or by the shareholders' meeting, at the beginning of their mandate and for the entire duration of their term of office (art. 2402 of the Italian Civil Code). This latter regulation is also designed to protect the auditors' independence, and shall not be subject to modifications of the Auditors' fees over the course of their appointment.

4. INDEPENDENCE AND PROFESSIONALISM

The members of the Collegio Sindacale must satisfy the requisites of independence and professionalism as foreseen by law.

As a result, auditors must be selected from among professionals registered in professional registers or university professors of law or economics. At least one regular member and one alternate member must be registered in the Register of Certified Auditors (art. 2397 of the Italian Civil Code).

In particular, the legislator grants auditors with a considerable degree independence from the Directors and from the majority of shareholders, and expressly provides for specific causes of ineligibility and of lapse (art. 2399 of the Italian Civil Code). The causes of ineligibility, such as the non-fulfillment of professional requisites or lack of independence, determine for any such appointed auditor the automatic expiry of their term of office.

The following are incompatible with the position of auditor:

- the relationship of spouse or of parenthood with the company Directors, but also with the Directors of the companies belonging to the same group (controlling, controlled and sister companies);
- a work relationship, professional relationship on a continuative basis or relationship for the supply of services for a consideration with the company and with the companies belonging to the same group (controlling, controlled and sister companies);
- more generally, any financial relationship which compromises the auditors' independence.

Additional causes of ineligibility and forfeiture, as well as further causes of incompatibility and limitations on interlocking directorships may be established by the company by-laws.



In the case of particular types of companies (banks, insurance companies, listed companies), the auditors must satisfy even more strict requisites of respectability, independence and professionalism. Thus, with respect to auditors of listed companies, Consob (i.e. the Italian Securities Regulator) sets specific limits on interlocking directorships in direction and control which may be undertaken in other companies (art. 148-bis T.u.i.f.).

Declaration of transparency

Prior to accepting the assignment, moreover, each auditor must make known to the shareholders' meeting (in the case of listed companies, also to Consob and to the public) any direction and control assignments that the latter has undertaken on behalf of other companies. The aim of this declaration is to orientate the auditor appointment process towards principles of correctness and transparency (art. 2400, fourth paragraph, of the Italian Civil Code and art. 148-bis T.u.i.f.).

5. DUTIES, POWERS AND OBLIGATIONS

Control over direction is exercised through direct and incisive power and duties to oversee the correctness and legitimacy of operations.

a) Attendance of the meetings of the Collegio Sindacale and of the management bodies

Auditors are obliged to take part not only in the meetings of the Collegio Sindacale, but also in those of the corporate bodies (art. 2405 of the Italian Civil Code). And indeed attendance of the meetings of the Board of Directors and of the shareholders is a useful instrument available to the Collegio Sindacale for fulfilling its oversight function.

The penalty for the non-fulfillment of these duties, moreover, is very serious, given that it envisages the loss of office for auditors who over the financial year miss two meetings, also non-consecutive and without justification, of the Collegio Sindacale (art. 2404, second paragraph, of the Italian Civil Code) or two consecutive meetings of the board of directors or of the executive committee or one meeting of the shareholders (art. 2405, last paragraph, of the Italian Civil Code).



b) Request of information on operations

The Collegio Sindacale may request information from the directors on the company's operating results or on given transactions, also with reference to controlled companies.

In particular, Managing Directors are obliged to report to the Collegio Sindacale on a periodical basis on the general performance of the company and on its business outlook, as well as on the more significant operations carried out by the company and its subsidiaries (art. 2381 of the Italian Civil Code).

Furthermore, the Collegio Sindacale may acquire and exchange information with the internal auditor, if present, as well as with the Collegio Sindacale and auditors of the subsidiaries (art. 2403-bis of the Italian Civil Code).

On the other hand, the right to information is even more highly-structured in listed companies, the Directors of which are under the obligation to report to the Collegio Sindacale in a timely manner, according to the modalities provided for by the company by-laws and at least on a quarterly basis, on the activities carried out and on the more significant economic, financial and capital transactions performed by the company and its subsidiaries. In particular, they report on the operations in which they detain personal interests, whether on their own behalf or on that of third parties, or which are influenced by the subject who manages and coordinates them. In parallel, each auditor also individually has the power to request a report from the Directors, also with reference to controlled companies, on the company's operating results or on given transactions; additional information may be requested not only to the audit firm, but also to those in charge of internal control (articles 150 and 151 T.u.i.f.).

The Collegio Sindacale, therefore, is the centre of a constant flow of company information which enables it – both through its own auditing initiatives (inspections and controls) and through the collaboration with the other corporate bodies – to carefully monitor the management of the company.

c) Inspections and controls

Auditors may, also individually, carry out inspection and control activities (art. 2403-bis of the Italian Civil Code). Consequently, they may carry out any inspection and control activity which they deem useful for the purpose of a diligent performance of the oversight function and have access to any information concerning the company management. In the fulfillment of this control activity, moreover, auditors may avail themselves – under their own responsibility and at their own expense – of their own assistants and employees.



Auditors report to the Collegio Sindacale on the results of the activities carried out. An account of these activities must be given in the minute book of the meetings and resolutions of the Collegio Sindacale (art. 2403-bis, third paragraph, of the Italian Civil Code).

d) Meetings

Among the duties imposed on the members of the Collegio Sindacale, the legislator has provided for that of meeting at least every ninety days (if permitted by the company by-laws also through IT means).

For the Collegio Sindacale to validly deliberate, the presence of the majority of its regular members is required, and the resolution must be passed by an absolute majority of those present. Dissenting auditors are entitled to have their dissent and the related reasons noted down.

A report must be drawn up for the meetings of the Collegio Sindacale, to be then registered in the book of meetings and resolutions and signed by the participants (art. 2404 of the Italian Civil Code).

e) Resolutions of the Collegio Sindacale and related documentation

The administrative control activities carried out by the Collegio Sindacale are documented in the book of meetings and resolutions of the same. The results of the individual audits are entered into the above said book, as they constitute the object of the Collegio Sindacale's resolutions.

Furthermore, important intervention powers are conferred upon the Collegio Sindacale in order to protect shareholders and third parties.

a) Convening of the shareholders' meeting

The Collegio Sindacale is empowered to convene the shareholders' meeting and proceeds to the necessary publications in case of omission or of unjustified delay on the part of the Directors.

The Collegio Sindacale is also empowered to convene the shareholders' meeting at any time when, during the fulfillment of its duties, the following occurs:

- it detects wrongful acts of a serious nature (also after they are reported by the shareholders);
- there is an urgent need to take measures.



The Collegio Sindacale of listed companies have the right to convene, in addition to the shareholders' meeting, also the board of directors or the executive committee, by giving prior notice to the chairman of the board of directors. The right to convene the board of directors or the executive committee may be exercised also separately by each member of the Collegio Sindacale, whilst the right to convene the shareholders' meeting must be exercised by at least two members of the Collegio Sindacale (art. 150 T.u.i.f). The right to convene the corporate bodies in listed companies is not subject to the occurrence of omission or unjustified delay on the part of the Directors.

b) Challenge of resolutions

The Collegio Sindacale has the right to challenge any resolutions of the board of directors that were not passed in compliance with the law and with the company by-laws within the meaning of art. 2388 of the Italian Civil Code, or which are in conflict with art. 2391 of the Italian Civil Code relating to the Directors' interests.

Furthermore, the Collegio Sindacale has various instruments for intervening in irregularities in the company's financial operations which are not related to the board of Directors, but rather, to the shareholders' meeting. In particular, the Collegio Sindacale may also challenge any resolutions of the shareholders' meeting that were not passed in compliance with the law and with the company by-laws.

c) Report to the Court

The Collegio Sindacale may report to the Court on any irregularities committed by the Directors in breach of their duties, which may cause damage to the company or to the controlled companies.

In the case of listed companies, the Collegio Sindacale is also held responsible for promptly reporting to Consob on any irregularities detected in the oversight activities, as well as for submitting the related minutes of the meetings and of the inquiries carried out and any other useful documentation.

d) Intervention at the request of the minority

The Collegio Sindacale shall endeavor in the presence of a report filed by the shareholders, to conduct all the necessary inquiries and give account of the latter in the annual report to the shareholders' meeting.

In the case where the report originates from many shareholders who represent one twentieth of the share capital (one fiftieth in companies that operate on the risk capital market), the Collegio Sindacale must



investigate without delay on the facts reported and present its conclusions and proposals, if any, to the shareholders' meeting. The company by-laws may provide for the report for lower percentage shares (art. 2408 of the Italian Civil Code).

e) Exercise of derivative litigation

The Collegio Sindacale may file derivative litigation against the Directors of a company (art. 2393, third paragraph of the Italian Civil Code).

Significant powers of proposal are also conferred upon the Collegio Sindacale.

a) The auditors' annual report

During the approval of the balance sheet, the Collegio Sindacale draws up a report, through which it provides to the shareholders' meeting an account of the operating results for the period and of the activities carried out in the fulfillment of its duties. It also provides its own observations and proposals in relation to the balance sheet and to its approval.

Special attention must be paid by the Collegio Sindacale in case the Directors have departed for specific reasons from the established valuation methods.

b) Opinions

Some provisions provide that the auditors, with reference to given resolutions, are called to express their opinion.

For example, the auditors' opinion must be previously and necessarily obtained in the following cases:

- In the event that the audit is assigned to an external auditor, where the Collegio Sindacale is called to express its opinion both at the time the task is assigned and in case of its revocation (art. 2409-*quater* of the Italian Civil Code).
- In order to establish the retribution of Directors who, in conformity with the company by-laws, have been vested with particular kinds of authority.



- When the resolutions of the shareholders' meeting are challenged by the shareholders, given that the Judge may decide to suspend the resolution after having "heard" the Directors and the auditors (art. 2378, fourth paragraph of the Italian Civil Code);
- In the event of proposals to increase the share capital with exclusion or limitation of the option right with respect to which the Collegio Sindacale must express its opinion on the congruity of the issue price of the shares (art. 2441, sixth paragraph of the Italian Civil Code).
- In the event of distribution of interim dividends with respect to which, amongst other things, the Collegio Sindacale must express its opinion on the information documents prepared by the directors (art. 2433-bis of the Italian Civil Code).

6. AUDIT

It is important to highlight the decision of the Italian legislator to vary the function of statutory audit of accounts based on the size and on the nature of the company.

- In the case of limited liability companies which do not exceed a given size limit (that is, limited liability companies whose share capital is less than 120,000 euro and which do not exceed the parameters referred to in art. 2435-bis of the Italian Civil Code related to the preparation of the abbreviated balance sheet), the appointment of the Collegio Sindacale is optional. In such case, in fact, the shareholders are free to decide whether or not to appoint a Collegio Sindacale (or, alternatively, an auditor), conferring upon the latter powers of internal audit and of statutory audit of accounting records.
- With regard to limited liability companies having a share capital equal to or greater than 120,000 euro, and which do not exceed the size limit provided for by the law for the preparation of the abbreviated balance sheet, the internal audits and the accounting controls are assigned by law to the Collegio Sindacale.
- Conversely, in the case of Joint Stock companies which do not operate on the risk capital market (so-called "private" companies) and do not prepare the consolidated balance sheet, the Collegio Sindacale may carry out, pursuant to a specific statutory provision, both the function of internal audit and that of statutory audit of accounting records. The joint exercise of these functions generates significant advantages as it creates an undeniable synergy and a more in-depth



knowledge of the company. At the same time, it enables the company to benefit from a significant cost reduction.

- Vice versa, in the case of listed joint stock companies and of joint stock companies which operate on the risk capital market (so-called “public” companies) and which prepare the consolidated balance sheet, where the risk or organizational complexity factors are very high, the legislator provides that the audits are assigned by law to different subjects. And in fact, in the case of “public” joint stock companies, the accounting control has to be exercised by an auditing company registered in the Ministerial Register and subject, within the limits of the auditing task, to the regulations governing the performance of the audit and to the supervision of Consob (art. 2409-bis, second paragraph of the Italian Civil Code); in the case of listed companies, on the other hand, the accounting controls are assigned to an auditing company registered in the Consob Register (art. 161 and subsequent of T.u.i.f.).

The separation between internal audits (assigned to the Collegio Sindacale) and accounting controls (assigned to an external auditor) is synonymous with the important role that the two types of controls play and with the need to ensure, in relation to the companies’ degree of openness to the market, that both are carried out in an effective and qualified manner.

If the accounting control function is also referred to the Collegio Sindacale, the auditors shall all be appointed from among the subjects registered in the auditors’ register. Consequently, they shall provide for the quarterly reports on the correct keeping of accounts and on the correct recognition of operating events; ensure that there is no material misstatement in the financial statement and that the latter is prepared in compliance with the accounting standards; as well as express an opinion on the financial statement. Furthermore, the Collegio Sindacale, which is in charge of the accounting control function, must draw up the annual report. Through the annual report, moreover, the auditors are called to express also their “opinion on the financial statements” (unqualified opinion, qualified opinion, disclaimer of opinion).



7. RESPONSIBILITIES

Diligence

It is the responsibility of the Auditor to fulfill its duties with the professionalism and diligence requested by the nature of the assignment (art. 2407 of the Italian Civil Code).

The auditor's diligence, therefore, is translated into the obligation to fulfill the oversight function with the skills and technical know-how proper to those who carry out auditing tasks, and which must correspond to the complexity and difficulty of the assignment.

Similar to what is provided for the Directors, auditors can be held liable to the company and to the creditors, but also to any single shareholder or third party that suffered direct damage as a result of acts of willful misconduct or serious negligence committed by the Directors.

Sole responsibility

In fact, Auditors have sole responsibility for the audit opinion expressed (this responsibility, moreover, is also punishable ex articles 2621 and subsequent of the Italian Civil Code) and, pursuant to the more general obligation of confidentiality, which is both a criminal offence (art. 622 of the Italian Criminal Code) and a breach of the rules of professional conduct (art. 10 of the Code of Professional Conduct of Certified Public Accountants and Accounting Experts), they are also responsible for keeping secret and strictly confidential any and all facts and documents of which they gained knowledge as a result of their task (art. 2407, first paragraph of the Italian Civil Code).

Shared responsibility

Auditors are also jointly liable with Directors for the latter's actions and omissions, when damage would not have been caused if they had carried out their oversight function in compliance with the legal provisions (art. 2407, first paragraph of the Italian Civil Code).

As far as the company's right to bring suit against the auditors is concerned, it is important to highlight the fact that derivative litigation may be filed by shareholders representing one fifth of the share capital (this percentage may be lowered or raised by the company by-laws, but only up to a maximum of one third of



the share capital). In the case of limited liability companies, derivative litigation may be filed also by a single shareholder, regardless of the number of shares held by the latter (art. 2476 of the Italian Civil Code).