



The Turnbull guidance as an evaluation framework for the purposes of Section 404(a) of the Sarbanes-Oxley Act

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1 Introduction

- 1.1 The Combined Code on Corporate Governance, published in July 2003 by the Financial Reporting Council, incorporates ‘Internal Control: Guidance for Directors on the Combined Code’ (the ‘Turnbull guidance’).
- 1.2 Since the Turnbull guidance was first published in 1999, the Sarbanes-Oxley Act of 2002 has been enacted in the United States and related rules have been prescribed by the Securities and Exchange Commission (SEC). Section 404(a) of the Act (‘S404(a)’) requires judgements regarding the effectiveness of material controls over financial reporting to be made in the context of a suitable framework. The SEC has identified the Turnbull guidance as one such suitable framework.
- 1.3 This guide aims to help non-US companies that are SEC registered (in this guide referred to as ‘SEC registrants’) who have elected to adopt the Turnbull guidance as a framework for S404(a) purposes. It describes the requirements of S404(a) and identifies those parts of the Turnbull guidance most relevant when complying with that section.
- 1.4 **The value of the Turnbull guidance in the context of S404(a) is solely as a framework within which to address the section’s requirements. Nothing in the Turnbull guidance reduces SEC registrants’ obligations to comply with US rules and regulations.**
- 1.5 This guide is not intended to be a comprehensive reference to compliance with S404(a) and SEC registrants are strongly advised to refer to the full legal requirements. References and links are provided in the Appendix. In addition, SEC registrants should consult with their professional advisors to ensure the implications of S404(a) compliance are fully understood.

2 Applicable requirements and effective date

- 2.1 S404(a) directed the SEC to prescribe rules mandating issuers to include an internal control report in their annual report.

Extract from the Sarbanes-Oxley Act 2002

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

- (a) **RULES REQUIRED.**—*The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—*
- (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and*
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.*

- 2.2 The requirements of S404(a) were implemented by the SEC within Rule 33-8238.

Extracts from SEC Rule 33-8238 (amendment to 17 CFR 240.13a-15 and 240.15d-15)

- (c) *The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.*
- (d) *The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.*

(f) *The term **internal control over financial reporting** is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:*

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;*
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and*
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.*

- 2.3 Foreign registrants (as opposed to US registrants) are required to comply with these regulations for fiscal years ending on or after 15 July 2005.¹
- 2.4 The Public Company Accounting Oversight Board (PCAOB) has issued Auditing Standard No. 2, which governs the report made by the external auditors under S404(b) on the statements made by management under S404(a). The provisions of Auditing Standard No. 2 are not affected by the choice of evaluation framework.
- 2.5 References to and extracts from US legislation and other requirements in this guide do not relieve SEC registrants of the obligation to have regard to all applicable regulatory requirements.

¹The timetable for the application of SEC Rule 33-8238 was extended by SEC Rule 33-8392. In practice, this means a foreign issuer with a calendar fiscal year-end will include an internal control report for the first time in its report on Form 20-F for the year ending 31 December 2005, to be filed by 30 June 2006.

3 The Turnbull guidance in a US context

3.1 When using the Turnbull guidance as a framework for S404(a) purposes, SEC registrants should be aware that:

- Irrespective of the framework adopted, all obligations arising from US securities law and SEC Rules must be complied with. In particular, appropriate documentation of processes and testing will be required to demonstrate compliance with SEC Rule 33-8238.
- Responsibility for compliance with S404(a) lies with the management of the company (as that term is understood in the US). By contrast, the Turnbull guidance, which is written in the context of UK corporate governance practice, imposes responsibility for internal control on both the board of directors and on the management of the company. In complying with S404(a), all the responsibilities described in the Turnbull guidance should be understood as being management's responsibilities.
- The 'comply or explain' approach to the Combined Code on Corporate Governance and the discretion this brings to the application of the Turnbull guidance in the UK are not applicable to compliance with US regulations. Consequently, those procedures set out within the Turnbull guidance must be observed for compliance with S404(a).
- Compliance with S404(a) calls for careful preparation, particularly with regard to the focus placed on testing and documentation.

3.2 As a result of the measures introduced by S404(a), reports filed with the SEC under Section 13(a) or 15(d) of the Securities Exchange Act (for example, reports on Form 20-F) are required to include an internal control report, containing:

- a statement setting out management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective;
- disclosure of any material weakness in the company's internal control over financial reporting identified by management; and
- a statement that the company's auditors have issued an attestation report on management's assessment of the company's internal control over financial reporting.

The filing is also required to include the auditors' attestation report within the company's annual report.

3.3 In order to be able to prepare its internal control report (and comply with the public reporting requirements), management is required to:

- undertake a review of the effectiveness of the internal control over financial reporting using a suitable framework such as the Turnbull guidance ('review requirements'); and
- maintain evidence to provide reasonable support for management's assessment of the effectiveness of internal control over financial reporting ('documentation requirements').

Management should be aware that US auditing standards require the company's auditors to review management's working papers and review process in preparing their attestation report. Whilst management is solely responsible for compliance with S404(a), they are allowed to make use of other resources, provided they are under their supervision.²

²The SEC has stated that management's responsibility should not be interpreted as meaning that management personally must conduct the necessary activities to evaluate the design and test the operating effectiveness of the company's internal control over financial reporting. Activities, including those necessary to provide management with the information on which it bases its assessment, may be conducted by non-management personnel acting under the supervision of management.

4 The application of the Turnbull guidance to meet review and documentation requirements

- 4.1 The review and documentation requirements contained in S404(a) are outlined in paragraph 3.3 above. This section expands on how these specific requirements can be discharged by management by applying the Turnbull guidance.

Framework

- 4.2 S404(a) requires an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and of the procedures of the issuer for financial reporting, making reference to ‘a suitable, recognized framework’. A suitable framework will provide process procedures and criteria for evaluating internal control. Footnote 68 to SEC Rule 33-8238 identifies the Turnbull guidance as an appropriate framework for this purpose.
- 4.3 The Turnbull guidance covers reviews of effectiveness of internal control, and specifies in paragraph 28 that the internal controls to be considered ‘should include all types of controls including those of an operational and compliance nature, as well as internal financial controls’. Consequently, the scope of S404(a) (which addresses internal control over financial reporting) is fully encompassed within the scope of the Turnbull guidance (which embraces internal control in its widest form). However SEC registrants should have regard to paragraphs 1.4 and 3.1 above when applying the Turnbull guidance in a US context.

The role of criteria in evaluating the effectiveness of the company’s internal control over financial reporting

- 4.4 SEC Rule 33-8238 requires management to conduct its evaluation by reference to a framework that includes criteria that will permit reasonably consistent qualitative and quantitative measurements of a company’s internal control.
- 4.5 PCAOB Auditing Standard No. 2 requires the external auditor to obtain an understanding of the design of controls relating to each component of the company’s internal control over financial reporting:
- control environment;
 - risk assessment;
 - control activities;
 - information and communication; and
 - monitoring.
- 4.6 These components are directly equivalent to the criteria identified in the Appendix to the Turnbull guidance, namely:
- risk assessment;
 - control environment and control activities;
 - information and communication; and
 - monitoring.

Review procedures and documentation

- 4.7 SEC Rule 33-8238 recognises that the methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. Consequently, that rule does not specify the method to be followed or the procedures to be performed in undertaking an evaluation. Further guidance on fulfilling management's documentation and testing responsibilities are provided in the SEC's Frequently Asked Questions in respect of SEC Rule 33-8238.
- 4.8 Paragraphs 29 to 34 of the Turnbull guidance provide guidance on how to perform a review of effectiveness. These are summarised below, together with references to the relevant paragraphs of the Turnbull guidance. These references are to be read in the context of paragraph 1.4 above.
- 4.9 The *process* to be adopted for the review of the effectiveness of internal control over financial reporting should be defined and should encompass the procedures to be adopted for the annual assessment, so that it provides sound and appropriately documented support for the internal control report (Turnbull guidance – paragraph 29).
- 4.10 In respect of *documentation*, and for the purposes of US compliance, management should have regard to the instruction within SEC Rule 33-8238 which reminds companies to maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of internal control over financial reporting.
- 4.11 The process should also establish the scope and frequency of reports to be received and reviewed during the year (Turnbull guidance – paragraph 29). These reports should provide a balanced assessment of the significant risks identified in the course of financial reporting and the effectiveness of the system of internal control established to manage those risks (Turnbull guidance – paragraph 30).
- 4.12 When testing the effectiveness of the internal control procedures for the purposes of US compliance, management should have regard to SEC Rule 33-8238. That Rule requires that the assessment of a company's internal control over financial reporting must be based on procedures sufficient, first, to evaluate its design and, secondly, to test its operating effectiveness. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment for the purposes of SEC Rule 33-8238.
- 4.13 The Turnbull guidance (paragraph 31) provides that the review of reports during the year should include:
- consideration of the significant risks and an assessment of how they have been identified, evaluated and managed;
 - assessment of the effectiveness of the related system of internal control over financial reporting in managing the significant risks, having regard, in particular, to any significant failings or weaknesses in internal control over financial reporting that have been reported;

- consideration of whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- consideration of whether the findings indicate a need for more extensive monitoring of the system of internal control.

4.14 The annual assessment should consider the issues raised in reports received during the year together with any additional information that may be necessary to ensure that account has been taken of all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts (Turnbull guidance – paragraph 32).

4.15 That annual assessment should, in particular, consider:

- the changes since the last annual assessment in the nature and extent of significant risks, and the company's ability to respond to changes in its business and the external environment;
- the scope and quality of management's ongoing monitoring of risks and of the system of internal control;
- the extent and frequency of the communication of results of monitoring, resulting in a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed;
- the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the company's financial performance or condition; and
- the effectiveness of the company's public reporting processes (Turnbull guidance – paragraph 33).

Classification of control deficiencies

4.16 S404(a) requires management to disclose any material weaknesses in the company's internal control over financial reporting. PCAOB Auditing Standard No. 2 (paragraphs 8 –10) identifies three classes of control deficiencies and provides definitions for each. Management should refer to those definitions when considering whether any material weaknesses exist. The definitions apply irrespective of the framework adopted.

Extract from PCAOB Auditing Standard No. 2

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.*
- A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.*

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

- 4.17 Appendices D and E to PCAOB Auditing Standard No. 2 give examples of significant deficiencies and material weaknesses. SEC Rule 33-8238 does not permit management to conclude that internal control over financial reporting is effective if their review identifies one or more material weaknesses.

5 Public reporting requirements

- 5.1 As explained in footnote 68 to SEC Rule 33-8238, management is required to make an explicit statement that the company's internal controls are, or are not, effective. The SEC has not specified the exact content of the report, as it considers this likely to result in boilerplate responses of little value. Instead, management should tailor the report to the company's circumstances. Against this background, it is recommended that management ensure that each of the requirements of S404(a) (summarised in paragraph 3.2 of this guide) be clearly and specifically addressed in management's statement.
- 5.2 SEC Rule 33-8238 requires a statement by management identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting. An appropriate description of the Turnbull guidance for public reporting purposes is 'Internal Control: Guidance for Directors on the Combined Code (the Turnbull guidance).'
- 5.3 S404(b) of the Sarbanes-Oxley Act requires the company's auditors to attest to and report publicly on the statement made by management. The form and content of the auditors' report is prescribed in PCAOB Auditing Standard No. 2.
- 5.4 The requirement to report any material changes to the company's internal control over financial reporting applies to foreign registrants (as well as US registrants), irrespective of the framework adopted. However, whereas US registrants are required to provide quarterly updates, foreign registrants are not required to file quarterly reports. SEC Rule 33-8238 clarifies that material changes to the company's internal control over financial reporting occurring during the year are to be disclosed in the company's annual report for that year.

6 Conclusion

- 6.1 Whilst the Turnbull guidance is a suitable framework for the purposes of S404(a) of the Sarbanes-Oxley Act, nothing in the Turnbull guidance reduces SEC registrants's obligations to comply with US laws and regulations.
- 6.2 This guide has summarised how the Turnbull guidance addresses:
- the processes and criteria needed to satisfy the US requirement that management perform a review of the effectiveness of a company's internal control over financial reporting; and
 - the procedures to be followed in order to maintain supporting evidence for that review.
- 6.3 This guide has also drawn attention to certain specific areas, additional to those covered by a suitable framework such as the Turnbull guidance, that require careful attention by management.
- 6.4 SEC registrants are urged to monitor best practice and guidance (in particular SEC and PCAOB Frequently Asked Questions) as they develop to ensure that internal control over financial reporting is and remains fully effective.

Appendix: Reference sources

- FRC, *Internal Control: Guidance for Directors on the Combined Code (the Turnbull guidance)*. Available for download from www.frc.org.uk/corporate.
- US Government Printing Office, *The Sarbanes-Oxley Act of 2002*. Available for download from www.gpoaccess.gov.
- SEC, Rule 33-8238, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*. Available from www.sec.gov.
- SEC, Rule 33-8392, *Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*. Available from www.sec.gov.
- PCAOB, Auditing Standard No. 2, *An audit of internal control over financial reporting performed in conjunction with an audit of financial statements*. Available for download from www.pcaobus.com.
- SEC, *Frequently Asked Questions 'Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports'*. Available from www.sec.gov.
- PCAOB, *Staff Questions and Answers 'Auditing Internal Control Over Financial Reporting'*. Available for download from www.pcaobus.com.
- COSO, *Internal Control – Integrated Framework (Executive Summary)*. Visit www.coso.org to view Executive Summary or to purchase the two-volume set including the COSO evaluation tools.
- AICPA, *A Framework for Evaluating Process/Transaction-Level Exceptions and Deficiencies*. (Prepared by nine major US public accounting firms). Available for download from www.aicpa.org.
- ISACA, *IT control objectives for Sarbanes-Oxley: The importance of IT in the design, implementation and sustainability of internal control over disclosure and financial reporting*. Available for download from www.isaca.org.