



REGULATORY IMPACT ASSESSMENT

REVIEW OF THE TURNBULL GUIDANCE ON INTERNAL CONTROL

Purpose and intended effect

1. Under the Combined Code on Corporate Governance, UK listed companies are required to maintain a sound system of internal control, review the effectiveness of that system at least annually, and include a statement on internal control in the annual report and accounts.
2. Published in 1999, the Turnbull guidance assists UK listed companies to implement the requirements of the Combined Code relating to internal control and reporting to shareholders thereon.
3. In July 2004 the Financial Reporting Council announced a review of the guidance. A working group consisting of representatives from business, the investment community and the accountancy profession was set up to carry out the review. The terms of reference were “to review and update where necessary the Turnbull guidance, in light of experience in implementing the guidance and developments in the UK and internationally since 1999, to ensure that it continues to meet its original objectives, which were that it should:
 - reflect sound business practice whereby internal control and risk management are embedded in the business processes by which a company pursues its objectives;
 - remain relevant over time in the continually evolving business environment; and
 - enable each company to apply the guidance in a manner which takes account of its particular circumstances.

To publish the revised guidance in time for it to take effect for accounting periods commencing on or after 1 January 2006”.



Business sectors affected

4. The outcome of this review directly affects those companies incorporated in the UK and fully listed on the London Stock Exchange, as they are required by the Listing Rules to report on how they have applied the Combined Code. As of August 2005 there are 1,232 such UK listed companies, operating across all business sectors on the Main Market

5. AIM and unlisted companies are not required to apply the Combined Code, and therefore are not required to follow the Turnbull guidance. However, there is evidence that some AIM and unlisted companies and organisations in other sectors of the economy have chosen voluntarily to follow the guidance. Any changes to the guidance as a result of the review may therefore also have an impact on them.

Issues

6. The review of the Turnbull guidance has considered three issues:

- the scope and content of the guidance to directors;
- disclosure of information about the internal control system; and
- the role of the external auditor in relation to the guidance.

7. The options considered for each of these issues, and the associated costs and benefits, are set out in the following sections.

Evaluation of the impact of the Turnbull guidance to date

8. Any assessment of the costs and benefits of any changes to the existing guidance and disclosure requirements must be informed by an understanding of the impact of the Turnbull guidance since its publication in 1999. The Review Group found that:

- the Turnbull guidance has contributed to greater awareness and improved management of risk among listed companies in the UK;
- the guidance is considered to have succeeded in its original objective that each company should be able to apply it in a manner which takes account of its particular circumstances, and in doing so had also succeeded in remaining relevant over time; but



- views differ on the extent to which the guidance has succeeded in embedding internal control in normal business processes and the extent to which companies have in practice reviewed their application of the guidance over time.

9. The Review Group carried out two public consultation exercises, the first seeking evidence on the impact and implementation of the Turnbull guidance and the second inviting comments on draft revised guidance. As part of the initial evidence-gathering phase of the review, MORI were commissioned to survey company directors and investors. The assessment of options that follows reflects the responses to those consultations and surveys.

The scope and content of the guidance

Options

Option 1: no significant changes to the Turnbull guidance but encourage companies to review on a continuing basis how they have applied the guidance.

Option 2: expand the guidance to provide more detail on how it should be applied.

Option 3: restrict the scope of the guidance and requirements of the Combined Code to internal controls relating to financial reporting.

Option 4: a combination of Options 2 and 3.

Costs and benefits

10. There are some important points which need to be taken into account in relation to the costs and benefits:

- The Turnbull guidance is intended as guidance, and the manner of its implementation is primarily the responsibility of the board of directors of individual companies. The direct cost to companies of applying the guidance will vary considerably depending on the way it has been implemented and the extent to which the company has been able to embed internal control within its existing processes, thus reducing the costs associated with setting up and monitoring new controls. 74% of company directors surveyed by



MORI¹ for this review said that risk management and internal control had been largely or fully integrated in normal business activity.

- In principle it is the company that gets the primary benefit from improved internal control – unlike the usual regulatory situation in which businesses are regulated for the benefit of others. However the benefits should ultimately flow through to shareholders. Companies whose standards of internal control are high are more likely to gain the confidence of investors and support for the development of their business. 88% of the investors surveyed by MORI said that risk management and internal control is a very or fairly important factor when they are making judgements about a company.
- 73% of company directors surveyed by MORI said that the guidance had helped to improve risk management and internal control in their company, while 70% of the investors surveyed thought that companies' understanding of risk had improved. There is anecdotal evidence that some companies may not be reviewing their application of the guidance on a regular basis. If this is the case, it is possible that their risk management and internal control may not be as effective as it could be.
- One might expect that allowing companies some flexibility in how they choose to apply the guidance would mean that companies would implement it in such a way that the perceived benefits at least equalled the costs, but it appears this has not always been the case. While 77% of company directors surveyed by MORI, who felt able to respond, considered the benefits had exceeded or equalled the costs, 23% felt that the costs had exceeded the benefits. This view is more prevalent among smaller listed companies. Anecdotal evidence suggests that there may be a correlation between the company's perception of the comparative costs and benefits and whether it views the Turnbull guidance as best practice guidance or a compliance exercise.

11. **Option 1** would not have a direct impact on the costs associated with the guidance. It would encourage but not require companies to consider whether improvements were needed to their internal control system, and allow them to make a judgement as to the balance of costs and benefits associated with doing so. If the company does so, it should derive benefit by ensuring that its understanding of the key risks it faces remains up to date.

¹ The findings of the MORI surveys are set out in more detail in 'The Review of the Turnbull Guidance on Internal Control: Evidence Paper', FRC, June 2005



12. **Option 2** could potentially lead to improved standards of internal control in some companies by in effect introducing a minimum standard for implementation of the guidance. However:

- There may be direct costs associated with meeting the more detailed requirements if this required the company, for example, to put in place new controls and monitoring arrangements, increase the frequency and level of detail of its reporting arrangements, or establish new functions such as internal audit or a risk committee. Any direct costs associated with meeting more detailed requirements would fall on all companies that had previously chosen to implement the guidance in a different way, regardless of the quality of their internal controls, and would not be targeted on those companies whose internal controls were considered to fall below the new standard.
- It was the strong view of all respondents to the consultation exercises that the benefits associated with the guidance to date have been achieved at least in part because of the absence of prescription, as boards have been required to think seriously about the issue and not simply delegate a piece of process to someone lower down the organisation. A greater degree of prescription might put these benefits at risk.
- A greater degree of prescription might lead to an increased perception that the guidance was a compliance exercise, which would adversely affect the balance of costs and benefits as perceived by companies.

13. At present the Turnbull guidance and the internal control requirements of the Combined Code cover all internal controls, including financial, operational and compliance controls. **Option 3** would limit coverage of the guidance to internal controls relating to financial reporting. This would bring the scope of the Combined Code and the guidance in line with the requirements of Section 404 of the Sarbanes-Oxley Act 2002, with which those UK companies registered with the SEC in the US have to comply, and potentially with the requirements of the draft revisions to the 4th and 7th Company Law Directives, which are currently going through the European legislative process.

14. In principle narrowing the scope of the Combined Code requirements to cover only internal control over financial reporting could result in cost savings for companies, and less duplication for those companies registered with the SEC². Arguably it might also encourage companies to devote more resource to improving their financial reporting controls. However:

² As at December 2004 (the most recent available information) 107 UK incorporated companies were registered with the US Securities and Exchange Commission.



- As part of the Operating and Financial Review (OFR) that they are now required to include in their annual reports, quoted companies will need to provide information on the principal risks that may affect long-term shareholder value. They will therefore need a process within the company to identify these principal risks, whether or not it is required by the Combined Code and Turnbull guidance.
- Other types of risks can often be more significant to the future of the company than financial reporting risks. Research by Deloitte into the causes of the 100 largest one-month declines in share price for the 1,000 largest international companies from 1994 to 2003 found that fraud or manipulation of accounting information featured in only a small number of those declines and that, for example, operational and external risks were more frequent causes³. Narrowing the scope of the Combined Code and Turnbull guidance might result in companies paying less attention to these risks. More likely, most companies would conclude that they needed to retain controls that enabled them to manage and monitor these risks, in which case any cost savings from amending the guidance would be limited.
- All respondents to the consultation exercise supported retaining the broader scope of the guidance.

15. It is considered that any benefits that may accrue from more prescriptive guidance as a result of higher standards of internal control in some companies would be outweighed by the direct compliance costs and loss of flexibility for the majority of companies, and that it is unlikely that limiting the guidance to controls related to financial reporting would result in any significant cost savings to companies without an increased exposure to other types of risks. **Option 1** is therefore recommended.

Disclosure

16. At present listed companies are required under the Listing Rules to report in their annual report and accounts on how they have complied with the internal control section of the Combined Code. This requires them to state how they have applied Principle C.2 of the Code (that they should have in place a sound system of internal control) and confirm that they have carried out at least annually a review of the effectiveness of that system, or explain why not. They are not required to comment on the outcomes of that review. The Turnbull guidance provides advice on how to meet these requirements.

³ 'Disarming the Value Killers: A Risk Management Study', Deloitte, 2005



17. For financial years beginning on or after 1 April 2005, listed companies are also required to include in their OFR a description of the principal risks and uncertainties facing them together with a commentary on the directors' approach to those risks.

Options

Option 1: no change.

Option 2(a): amend the provisions of the Combined Code to require further mandatory disclosure; or

Option 2(b): amend the Turnbull guidance to encourage further voluntary disclosure.

Option 3(a): require companies to express an opinion on the effectiveness of the internal control system in the annual report; or

Option 3(b): require companies to confirm that necessary action had been or is being taken to remedy any significant failings or weaknesses identified from the annual review of the effectiveness of the internal control system.

Costs and benefits

18. Anecdotal evidence from the consultation exercise suggests that the existence of a requirement to disclose information about the internal control system and confirm that an annual review has been carried out has helped to focus boards on the need to manage risk, and in doing so has helped to improve overall standards of risk management and internal control.

19. Investors appear to get some value from the current disclosures made under the Combined Code, mainly as a form of health check. In the words of one investor, *"the disclosures are rather like audit reports insofar as if they weren't there, they would by their absence undermine the confidence which investors would place in the control environment"*.

20. It also appears that institutional investors do not primarily rely on the internal control statement in coming to an overall judgement about the quality of a company's risk management. However, many of the investors that responded to the initial consultation exercise felt that their judgements would be aided by more informative disclosures that were specific to the company, in particular in relation to key risks. **Option 1** may not deliver these benefits, although it would also not impose costs on companies.



21. At present the Turnbull guidance sets out minimum standards for meeting the requirements in the Combined Code, and makes suggestions as to how companies could go further in providing information that shareholders would find useful. **Option 2(a)** would strengthen the mandatory requirements in the Combined Code, possibly by moving some of the material in the guidance into the Code itself. **Option 2(b)** would provide stronger encouragement to companies to provide such information.

22. In principle the direct costs on companies of either option should be limited if all that is required of them is to describe systems or processes that are already in place. The more prescriptive the requirements the greater the potential cost. Companies have expressed concern that they should not be expected to disclose commercially sensitive information that might put them at a disadvantage compared to their competitors that are not listed and therefore not subject to any disclosure requirements. The likelihood of this occurring under either option depends on what information they are being asked to disclose, but **Option 2(b)** would provide companies with greater flexibility to decide what to disclose.

23. There should be some benefits for investors as a result of more informative disclosure, and these benefits should in principle be more reliably delivered by **Option 2(a)**. However:

- that would only be the case if companies felt comfortable providing the specified information. If not, the result might be boilerplate disclosures that provided little useful information for investors;
- it is not clear how significant any benefits would be. In its response to the initial consultation exercise the Investment Management Association stated that *“although more detailed and descriptive disclosures would assist investors they are not vital to a decision as to whether to buy a particular company’s shares or to retain an existing holding”*; and
- the issue on which investors expressed the greatest desire for additional information was the company’s key risks. This need should largely be met through the OFR.

24. On balance the Review Group concluded that imposing additional mandatory requirements would not be proportionate to the benefits likely to be obtained. **Option 2(b)** is therefore recommended.



25. **Option 3(a)** would mirror the requirements placed on companies listed in the US by Section 404 of the Sarbanes-Oxley Act 2002, although it would be broader in scope as the US requirement is restricted only to internal controls over financial reporting.

26. Benefits identified with this requirement in relation to financial reporting in the US include increased involvement on the part of senior management, broader awareness of internal control throughout the organisation, more formal corporate policies and improved documentation of controls. Many of these benefits have also been attributed to the Turnbull guidance in the UK.

27. There could be some benefit for UK companies that will become subject to Section 404 if they were only required to comply with one set of disclosure requirements. However this would only be the case if the scope of the UK guidance and disclosure requirements was brought in line with the US requirements and limited to internal control over financial reporting. As noted in paragraph 13, there was no support for limiting the scope of the guidance in this way, as the broader scope is considered to have delivered many benefits. Even if the scope were to be narrowed, **Option 3(a)** would impose additional costs on the large majority of UK listed companies not registered with the SEC.

28. There was very little support for **Option 3(a)** among respondents to the initial consultation exercise. The main reasons were:

- the perceived costs associated with implementation of Section 404 in the US. Figures published in March 2005 by Financial Executives International (FEI)⁴, estimated the average cost for companies in the first year of implementation at \$4.36 million (£2.3 million). There was concern that the costs would be higher in the UK because the company would be required to cover a much larger number of controls;
- the concept of effectiveness is not considered a meaningful one for public reporting purposes when considering many operational issues, where the company's response to risk is determined by their risk appetite and cannot be mandated by reference to some objective standard;
- the possible creation of an expectations gap, with a declaration that the internal control system was effective being taken to mean that nothing could go wrong;

⁴ March 2005 survey by Finance Executives International, details are available at http://www.fei.org/404_survey_3_21_05.cfm



- concern that, due to a desire to avoid the risk of litigation, the outcome would be long, legalistic disclosures that provided little value for investors; and
- a concern that such a requirement might result in companies focusing on compliance at the expense of substantive assessment and management of risk.

29. The direct costs of **Option 3(b)** should be limited. The Turnbull guidance already requires companies to consider necessary action and reassess the effectiveness of the internal control system in the event of a significant failing or weakness being identified, so disclosing the fact that this has been done should not in itself create a new burden. Some companies may consider that making such a statement puts them at a disadvantage, although none of the listed companies that commented on the draft revised guidance raised this as a concern; others, on the other hand, might see a benefit in providing investors with some additional reassurance that the company is capable of identifying and addressing any weaknesses in internal control. **Option 3(b)** is therefore recommended.

The role of the external auditor

30. External auditors are required under the Listing Rules to review the directors' compliance statement relating to its review of the internal control system (provision C.2.1 of the Combined Code). The Auditing Practices Board's (APB) guidance suggests that auditors should evaluate whether the company's published statement on internal control is supported by documentation and appropriately reflects the board's process of reviewing the system of internal control. The external auditors will add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge.

31. In contrast to the requirements in the US under Section 404(b) of the Sarbanes-Oxley Act 2002, auditors are not required to issue a statement on the effectiveness of the internal control system. The auditor's responsibilities under Section 404 relate only to internal controls over financial reporting. In the UK the board's review – and, as a result, the auditor's review of it – covers all types of control.

Options

Option 1: no change.



Option 2: require the external auditor to express a public opinion on the effectiveness of the internal control system.

Option 3: give the external auditor an extended role in assessing the internal control system, but without being required to express a public opinion.

Costs and benefits

32. The general view of respondents to the consultation exercise was that the activities of the external auditor in reviewing the company's internal control statement, while limited, provided some assurance to boards and shareholders and should therefore continue to be undertaken. However some investors considered that the auditors' oversight role in relation to the internal control statement may inhibit fuller disclosure by the company. There was no support for extending the role of the auditors.

33. **Option 1** would not have a direct impact on either the costs or benefits associated with the external auditors' role in relation to the internal control statement. Respondents considered that the external auditors' existing role provided a degree of assurance to the board and shareholders.

34. **Option 2** could potentially lead to improvements in the overall level of internal control, either directly if individual companies strengthened their internal control system in order to ensure a positive opinion, or indirectly if investors began to use auditors' opinions as a means of differentiating between companies when making investment decisions.

35. However, early evidence from the implementation of Section 404(b) in the US suggests that such a requirement could potentially lead to significant costs for the company. According to March 2005 data published by FEI the average auditor fees in relation to Section 404 in the first year of implementation were \$1.3 million (£690,000)⁵. Companies also incurred additional costs as a result of the need to develop and maintain documentation in order to meet the auditors' need to obtain evidence of the effectiveness of all relevant controls.

36. As the Turnbull guidance covers all internal controls, not just financial reporting controls, concerns were expressed by respondents to the consultation exercise that the potential costs would be even higher in the UK as the auditors would be required to make an assessment of the effectiveness of a much larger number of controls.

⁵ *ibid*



37. The majority of respondents considered that there would be limited benefit to either the company or investors from the auditors undertaking such activity. It was considered that it was not appropriate for the auditors to be asked to second guess the board's decisions about how to respond to many non-financial reporting risks that could not be measured against an objective standard, nor were they qualified to do so, and that the existing role of the external auditors was sufficient.

38. For many of the same reasons, respondents considered that any benefits associated with **Option 3** would be limited.

39. As the benefits of any extension to the role of external auditors are considered to be limited, and in view of the potential costs associated with requiring auditors to give a public opinion on the effectiveness of the company's internal controls, **Option 1 is recommended.**

Smaller listed companies

40. The Turnbull guidance sets out high-level principles for maintaining and reviewing a sound system of internal control. The aim is that the company should be able to apply it in a way that is appropriate to the company's circumstances and proportionate to the risks that the internal control system is intended to manage.

41. The MORI survey of company directors found an apparent link between company size (as measured by market capitalisation) and the balance of costs and benefits from implementing the existing Turnbull guidance. 29% of directors of listed companies with a market capitalisation of below £100 million said that the costs of implementing the existing guidance had exceeded the benefits, with only 21% saying the benefits had exceeded the costs and 50% saying that implementation had been cost neutral. This contrasts with the experience of directors of the largest companies (those with a market capitalisation of over £500 million), of whom only 16% said the costs had exceeded the benefits, while 48% said that benefits had exceeded costs. These figures exclude those directors who felt unable to respond to the question.



42. These figures may in part reflect differing perceptions of the Turnbull guidance, with some companies seeing it as sound business practice and others seeing it as a regulatory compliance exercise. But they may also suggest that if, notwithstanding the inherent flexibility of the current guidance, smaller companies are more likely than others to feel that the costs have outweighed the benefits, then changes that reduced that flexibility may have a disproportionate impact on smaller listed companies.

Enforcement and sanctions

43. Under the UK Listing Authority's Listing Rules, a listed company incorporated in the UK is required to include in its annual report and accounts:

- a statement of how it has applied the principles set out in Section 1 of the Code, providing explanation which enables its shareholders to evaluate how the principles have been applied. Principle C.2 of the Code states that “the board should maintain a sound system of internal control to safeguard shareholders’ investments and the company’s assets”; and
- a statement as to whether or not it has complied with the Code provisions set out in Section 1 of the Code. The company must specify the Code provisions, if any, with which it has not complied and give reasons for non-compliance. Provision C.2.1 states that “the board should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems”.

44. The Financial Services Authority, as Listing Authority, makes no judgement on the accuracy or adequacy of the compliance statements made by listed companies: these are matters for the judgement of directors and shareholders. If a company fails to include a statement in the required form it may, however, use its enforcement powers, including its fining powers, against that company.

Consultation

45. While the Financial Reporting Council is responsible for the Turnbull guidance, the review has been carried out by a group of market practitioners. Chaired by Douglas Flint, Group Finance Director of HSBC Holdings plc, the members of the group were drawn from listed companies, the investment community and the accountancy profession.



46. The Review Group undertook a two-stage review. The first stage, intended to gather evidence on the impact of the Turnbull guidance and views on whether and how it should be amended, included:

- a three month public consultation exercise, running from December 2004 to March 2005, to which 103 responses were received. Responses to the consultation exercise were received from listed companies representing 56% of the total market capitalisation of UK companies listed on the London Stock Exchange's Main Market, from institutional investors that are between them responsible for funds under management in excess of £2,350 billion, from many representative bodies and most of the major accountancy firms;
- telephone surveys of 114 company directors and 50 investors, carried out by MORI; and
- focus groups and other discussions with interested parties.

47. A second consultation on the Review Group's recommendations will be carried out between June and September 2005. 54 responses were received, including from companies representing over 31% of the total market capitalisation of UK companies listed on the London Stock Exchange's Main Market and from institutional investors and investor representative bodies that are between them responsible for funds under management in excess of £3,100 billion, as well as many accountancy firms and other representative bodies. All respondents supported the broad approach taken by the Review Group.

Consultation with regulators

48. A Government observer from the DTI attended meetings of the Review Group. The Review Group also consulted HM Treasury and the Financial Services Authority and two of the FRC's operating bodies: the Accounting Standards Board (responsible for the OFR reporting standard) and the Auditing Practices Board (responsible for providing guidance to external auditors on their responsibilities in relation to the Combined Code).

Monitoring and review

49. The FRC will continue to monitor implementation of the Combined Code and its related guidance, including the Turnbull guidance.



Summary and recommendations

50. There is evidence that the Turnbull guidance has contributed to greater awareness and improved management of risk among listed companies in the UK, and that the non-prescriptive nature of the guidance has contributed to its success by encouraging companies to focus on the key risks facing them and allowing them flexibility to tailor the guidance to their particular circumstances. It is considered that any benefits that may accrue from more prescriptive guidance as a result of higher standards of internal control in some companies would be outweighed by the direct compliance costs and loss of flexibility for the majority of companies. **It is therefore recommended that there should be no significant changes to the scope and content of the guidance.**

51. Investors would welcome more informative disclosure by companies, but acknowledge that the internal control statement is in itself of limited value when reaching an overall assessment about the quality of a company's risk management. Any changes need to be proportionate to the likely benefit. In addition, the introduction of the OFR should go a long way to meeting investors' desire for more information about the key risks faced by the company. **It is therefore recommended that no new mandatory requirements should be introduced, but the Turnbull guidance should be amended to encourage more informative disclosure, including by requiring boards to confirm that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from the annual review.**

52. It is considered that there would only be very limited benefits in extending the current role of external auditors, and that doing so could potentially lead to a significant increase in costs to listed companies, particularly if the auditor were required to give a public opinion on the effectiveness of the internal control system. **It is therefore recommended that there should be no expansion of the role of the external auditor.**

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