



# Review of the Turnbull Guidance on Internal Control

---

Proposals for updating the guidance

*Consultation Paper*

Turnbull Review Group

16 June 2005

# Review of the Turnbull Guidance on Internal Control

## Proposals for updating the guidance *Consultation Paper*

### Contents

	Page
Responding to this consultation paper	1
1. Introduction and summary of recommendations	2
2. Experience of implementing the Turnbull Guidance	6
3. The scope and content of the guidance	9
4. The internal control statement	15
5. The role of the external auditor	23

### Appendices

A1. Draft revised guidance	25
A2. Draft revised guidance (with proposed changes highlighted)	36
B. The UK regulatory framework	49
C. Draft Regulatory Impact Assessment	53
D. Members of the Review Group and its Terms of Reference	65

# Responding to this consultation paper

Comments are invited on the recommendations in this consultation paper (summarised on page 5), the draft revised guidance (Appendix A) and the draft Regulatory Impact Assessment (Appendix C).

The deadline for responses is **16 September 2005**. The intention is to publish the revised guidance as soon as possible thereafter, and for it to take effect for financial years beginning on or after 1 January 2006.

Please e-mail or post your responses to this consultation paper to:

E-mail: [turnbullreview@frc.org.uk](mailto:turnbullreview@frc.org.uk)

Postal address:

The Turnbull Review Group  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

Telephone enquiries: Chris Hodge (FRC) on 020 7492 2381.

Unless otherwise stated, responses will be regarded as being on the public record. Consultees should indicate specifically whether their responses should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).

This document is available on the FRC website at:

[www.frc.org.uk/corporate/internalcontrol.cfm](http://www.frc.org.uk/corporate/internalcontrol.cfm)

where follow-up documents relating to the review will appear in due course.

Also available on the FRC website is the evidence paper that:

- analyses the responses to the evidence gathering public consultation paper;
- presents the main findings from telephone surveys of company directors and investors; and
- summarises other information.

© 2005 Financial Reporting Council

Dissemination of the contents of this consultation paper is encouraged.

Please give full acknowledgement of source when reproducing extracts in other published works.

# 1. Introduction and summary of recommendations

## Introduction

- 1.1. In July 2004 the Turnbull Review Group was invited by the Financial Reporting Council (FRC) to review the impact of the Turnbull guidance since its introduction in 1999, and to consider whether it needed to be updated. In December 2004 the Review Group issued an evidence gathering consultation paper.
- 1.2. Responses to the evidence gathering consultation paper 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 from most of the major accountancy firms. The Review Group supplemented this consultation exercise with telephone surveys of company directors and investors, and a series of focus groups and other discussions.
- 1.3. The evidence gathered represents the views and experience of a significant proportion of the London market, both companies and investors. Those views carry considerable weight when considering whether any changes are needed.
- 1.4. There was a strong degree of consistency of opinion on the main issues, with the overwhelming view of respondents being that the Turnbull guidance has been a notable success and that companies have been able to implement it intelligently and appropriately. The evidence suggests that the guidance has contributed to better understanding and management of risk and improvements in internal control.
- 1.5. It was the strong view of both companies and investors that this success was in large part attributable to the breadth and principles-based approach of the guidance. By covering all material controls and linking internal control to risk management, it allowed companies to focus on the most significant risks facing them. By setting out high-level principles rather than detailed processes, it required boards to think broadly about their company's risks and enabled them to apply the guidance in a way that suited the circumstances of their company. The clear message from the consultation exercise and other discussions was that these strengths should be retained. This is reflected in the Review Group's recommendations.
- 1.6. The Review Group considered carefully whether to make changes to the guidance in order to achieve further improvement, and concluded that it would be inappropriate to prescribe a minimum standard for implementing the guidance. The evidence suggests 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 internal control and not simply delegate a piece of process to a project team lower down the organisation. It was this top level consideration of control issues, encouraged by the Turnbull guidance, which investors found particularly beneficial. Those companies that have derived most benefit from the guidance also appear to be those that viewed it as good business practice rather than simply a compliance exercise.

- 1.7. Although being more prescriptive about how companies are expected to implement the guidance might arguably raise standards of internal control in some companies, the Review Group believes this would be at the expense of many of the benefits already delivered and could potentially impose unwarranted additional cost on all companies. The Review Group believes that more is likely to be achieved by companies regularly reassessing their application of the guidance to identify where improvements could be made or changes are needed. Many companies already do this. Others risk forfeiting the benefits they have already gained unless they take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. The Review Group proposes to use a new preface to encourage companies to review on a continuing basis their application of the guidance.
- 1.8. There is always the temptation when carrying out a review such as this to make detailed changes to demonstrate that a thorough job has been done. The Review Group has tried to resist that temptation. In considering possible substantive changes to the guidance, the Review Group applied four tests:
- Does the proposed change address an issue that is not already substantially covered by the existing guidance?
  - Is a change to the guidance the most appropriate way to address the issue concerned?
  - Would any proposed change materially improve internal control and risk management at a reasonable cost?
  - Would any proposed change restrict a company's ability to apply the guidance in a manner suitable to its own particular circumstances?
- 1.9. Having taken this approach, the Review Group proposes only limited changes to those parts of the guidance dealing with maintaining and reviewing the internal control system. These are set out in paragraph 3.22 of this consultation paper.
- 1.10. The Review Group recognises that some companies may find it helpful to have further good practice guidance on some aspects of risk management and internal control, but considers that any additions to the Turnbull guidance would risk being interpreted as setting out firm requirements, whether or not that was the intention. The Review Group believes that it is for the market to respond to demand for good practice guidance.
- 1.11. The Review Group also invited views on the statement on internal control that companies are required to include in the annual report. Inevitably, debate on this issue was coloured by perceptions of the impact of Section 404 of the Sarbanes-Oxley Act in the US.
- 1.12. Care needs to be taken when comparing the relative merits of Section 404 and the Turnbull guidance, as there are significant differences in scope and approach. Both are parts of a broader regulatory framework, and both are products of those frameworks. The US approach is usually characterised as being rules-based, while the UK approach is principles- and market-based (as epitomised by 'comply or explain' and the Combined Code). Importantly, Section 404 is concerned only with internal controls over financial reporting, while the Turnbull guidance covers all controls.

- 1.13. Nonetheless the Review Group considered whether the disclosure requirements of Section 404 – which requires the company’s management to make a statement on the effectiveness of internal controls over financial reporting, and the external auditor to issue an attestation report on that statement – constitute an appropriate model for disclosures made in the UK under the Combined Code and Turnbull guidance.
- 1.14. The Review Group concluded that they do not. In part this is because of the broader scope of the Combined Code and Turnbull guidance. The Review Group does not consider that the concept of ‘effectiveness’ would be meaningful for public reporting purposes when considering many operational risks, for example, where the company’s response is determined by its risk appetite and cannot be mandated by reference to some objective standard.
- 1.15. In addition, in the Review Group’s opinion a requirement for a statement that processes are effective would be bound to lead to expensive testing and verification work to a low level of detail. The Review Group did not consider the benefit of such a statement to shareholders would be sufficient to recommend that it should be required, and was concerned that it might result in a focus on compliance rather than substantive assessment and management of risk, undermining what was seen as one of the main strengths of the Turnbull approach.
- 1.16. The Review Group received little encouragement from investors to recommend Section 404 style disclosures. Instead, investors stated they are looking for company-specific disclosures which provide them with some assurance that the key risks facing the company have been identified and are being managed, and which highlight areas of focus and improvement. The Review Group considered that this demand should in part be met by the new mandatory Operating and Financial Review (OFR).
- 1.17. The Review Group concluded that it would not be appropriate to be too prescriptive about what other information companies should include in their internal control statement for the same reason that it would not be appropriate to be prescriptive about how the guidance should be implemented. Companies should be able to exercise judgement about what information to include.
- 1.18. Taken together with the OFR, the internal control statement provides an opportunity for the board to communicate to its shareholders how it manages risk effectively. The Review Group encourages boards to consider how they might provide their shareholders with the sort of tailored information they find useful without compromising the commercial interests of the business. The Review Group also considers that it would provide some additional reassurance to shareholders if boards were to confirm in the internal control statement that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from the reviews of the effectiveness of the internal control system.
- 1.19. The Review Group believes that the detailed recommendations set out in this consultation paper are supported by a consensus of opinion that emerged from the evidence-gathering phase of this review. The Review Group is grateful to all those who responded to the consultation exercise, participated in the telephone surveys and focus groups or otherwise contributed to the development of these proposals.

## Summary of recommendations

- A. Significant changes to the Turnbull guidance are not required (paragraph 2.12).
- B. The guidance should continue to cover all internal controls (paragraph 3.11).
- C. No changes should be made to the guidance that would have the effect of restricting a company's ability to apply the guidance in a manner suitable to its own particular circumstances (paragraph 3.12).
- D. A new preface should be added to the guidance which will encourage boards to review on a continuing basis their application of the guidance (paragraph 3.18) and look on the internal control statement as an opportunity to communicate to their shareholders how they manage risk effectively (paragraph 4.40).
- E. The guidance should be amended to:
  - (i) reinforce the message that the guidance is intended to reflect sound business practice as well as help companies comply with the internal control requirements of the Combined Code, by re-ordering the introduction to the guidance (paragraph 3.22);
  - (ii) reflect changes in the Combined Code and Listing Rules (paragraph 3.22);
  - (iii) require the board to exercise reasonable care, skill and diligence when forming a view on the effectiveness of the internal control system to reflect the proposed statement of directors' duties in the draft Company Law Reform Bill, rather than forming a view "after due and careful enquiry" (paragraph 3.22);
  - (iv) remove the section relating to internal audit, which is now dealt with in provision C.3.5 of the Combined Code, and which the FRC should incorporate into the Smith guidance on audit committees (paragraph 3.22); and
  - (v) require boards to confirm that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from their review of the effectiveness of the internal control system (paragraph 4.29) and to include in the annual report and accounts such information as the board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control (paragraph 4.39).
- F. It is not appropriate to require boards to make a statement in the annual report and accounts on the effectiveness of the company's internal control system (paragraph 4.24).
- G. There should be no need for companies that are already applying the Turnbull guidance to develop additional processes in order to comply with the requirement to identify principal risks in the OFR (paragraph 4.33), but companies are encouraged to ensure that the OFR and the internal control statement are complementary (paragraph 4.36).
- H. There should be no expansion of the external auditors' responsibilities in relation to the company's internal control statement (paragraph 5.11).
- I. Revised guidance taking account of the changes identified in D and E above should take effect for financial years beginning on or after 1 January 2006.

## 2. Experience of implementing the Turnbull Guidance

### Background

- 2.1. The Turnbull guidance is one part of a broader UK framework of regulation relating to internal control. This framework is summarised in Appendix B.
- 2.2. Before considering whether there is a case for changing the Turnbull guidance, it is necessary to look at the impact it has had since being introduced in 1999, the way it has been implemented by companies and the extent to which it has met its original objectives, which were to:
  - reflect sound business practice whereby internal control is 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 it in a manner which takes account of its particular circumstances.
- 2.3. The Review Group invited views on the impact of the guidance as part of its public consultation exercise, to which over 100 responses were received. This was supplemented by telephone surveys of company directors and investors, carried out by MORI, as well as by a series of focus groups and interviews.

### Evidence

- 2.4. The evidence obtained on the impact of the Turnbull guidance on boards' understanding and management of risk and the extent to which the guidance has met its original objectives is set out in more detail in section 1 of the evidence paper.
- 2.5. There is evidence that the Turnbull guidance and the requirement in the Combined Code for companies to disclose certain information in their annual report and accounts has contributed to greater awareness and improved management of risk among listed companies in the UK. 73% of company directors surveyed by MORI said that the guidance has helped to improve the quality of risk management and internal control in their company, while 70% of the investors surveyed thought that companies' understanding of risk has improved.
- 2.6. These findings are strongly supported by anecdotal evidence from responses to the consultation exercise. The guidance is widely considered to have been a success. In its response, the Institute of Chartered Secretaries and Administrators said that the guidance was "*largely considered [to be] the most effective piece of corporate governance guidance to have appeared in the UK over the last 10 years or so*".
- 2.7. The vast majority of responses, from investors as well as companies, took the view that no significant change was needed, in part reflecting concerns over the burden a more prescriptive framework would impose and in part acknowledging the achievement of the current guidance. It is believed that



this success is largely attributable to the breadth and principles-based approach of the guidance. By covering all controls and linking internal control to risk management, it has allowed boards to focus on the most significant risks facing them. By setting out high-level principles rather than detailed processes, it has enabled them to apply the guidance in a way that fitted their own circumstances.

- 2.8. The Review Group is aware that the guidance has been adopted and adapted by other organisations in the UK that are not subject to the Code, which supports the view that it has proved to be sound business practice.
- 2.9. It was the strong view of respondents that the guidance had 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 that by doing so it had also succeeded in remaining relevant over time. This view is supported by the company directors surveyed by MORI, 89% of whom felt that the guidance could be adapted very or fairly well to suit a company's particular circumstances. However, some respondents felt that in some companies the initial impetus provided by the Turnbull guidance had not been maintained, and were concerned that those companies may not be paying sufficient attention to the impact of changes in their circumstances.
- 2.10. Views differ on the extent to which the guidance has succeeded in its third objective of embedding internal control in normal business processes, although the majority view was that it had done so. Nearly three-quarters of the company directors surveyed by MORI said that risk management and internal control had become largely or fully integrated in the standard operating practice for normal business activity at their company. Anecdotal evidence from the consultation exercise and other discussions suggests that the extent to which internal control has become embedded may in part depend on the approach taken by the board. It was felt that those companies that viewed internal control as sound business practice were more likely to have embedded it into their normal business processes, and more likely to feel that they had benefited as a result, than those that viewed it primarily as a compliance exercise.
- 2.11. It appears that company size may be a factor in the way the guidance has been implemented. While 65% of directors at companies with a market capitalisation of under £100 million said that risk management and internal control had been largely or fully integrated in normal business activity, this rose to 87% at companies with a market capitalisation of over £500 million. Similarly, while the majority of company directors surveyed by MORI felt that the benefits of implementing the Turnbull guidance had exceeded or equalled the costs, directors at small companies were more likely than those at large companies to feel that the costs had exceeded the benefits.

## Analysis and recommendations

- 2.12. The case for specific changes to the guidance and disclosure requirements is considered in the following sections. But in the light of evidence that the Turnbull guidance has contributed to improvements in risk management and internal control, and the strong support from all sectors for the guidance in its current form, **the Review Group agrees with respondents that significant changes to the Turnbull guidance are not required.**
- 2.13. The regulatory framework relating to risk management and internal control in the UK is summarised in Appendix B. During the course of this review additions to this framework have been made and proposed. In the OFR, which listed companies are required to include in their annual reports for financial years beginning on or after 1 April 2005, companies are expected to describe the principal risks and uncertainties facing them. In March 2005, the Department of Trade and Industry (DTI) published the Company Law Reform White Paper<sup>1</sup>, which contains proposals to codify in company law some of the directors' duties currently in common law.
- 2.14. These recent changes reinforce the Review Group's view that the Turnbull guidance is part of a robust regulatory framework relating to risk management and internal control, and that the focus of this review should be on ensuring that the guidance remains effective rather than seeking to expand it to address issues better addressed by other parts of that framework.

---

<sup>1</sup> 'Company Law Reform', Cm 6456, HMSO, March 2005

## 3. The scope and content of the guidance

### Background

- 3.1. The Turnbull guidance applies to all aspects of internal control, including financial, operational and compliance matters. In line with the UK approach to corporate governance based on principles and ‘comply or explain’, the guidance is intended to be capable of being applied to a company’s specific circumstances. The guidance covers:
- the responsibilities of boards and others for maintaining a sound system of internal control and the elements of such a system;
  - the responsibilities of boards for reviewing the effectiveness of internal control and the process for their review; and
  - the board’s statement on internal control (which is addressed in section 4).
- 3.2. The Review Group stated in its initial consultation paper that when considering possible changes to the guidance it would pay particular attention to the potential impact of such changes on:
- the ability of companies to achieve better their business objectives;
  - the ability of investors to make better informed decisions in pursuance of their investment strategies;
  - improving confidence in corporate reporting and governance;
  - the balance of costs and benefits; and
  - the perceived impact on litigation risk and liability.

### Evidence

- 3.3. The evidence obtained on the scope and content of the Turnbull guidance, and views on whether changes should be made, is set out in more detail in section 2 of the evidence paper.
- 3.4. There was overwhelming agreement among respondents to the consultation exercise that the guidance should continue to cover all internal controls, as this had encouraged companies to focus on their most significant risks. The CBI was of the view that *“the Turnbull approach represented a leap forward for many companies in focusing on the broader reasons why businesses fail rather than the purely financial ones. This key change has led to better risk management”*.
- 3.5. The breadth of coverage was seen as a major strength of the Turnbull guidance in comparison with other approaches that focused narrowly on financial reporting controls. One listed company noted in its response that *“emphasis only on financial control is a very narrow focus and does not take into account the overall custodial responsibility of the directors who have been entrusted with properly managing the risks to which the shareholders’ invested capital is exposed”*. 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 causes<sup>2</sup>.

- 3.6. There was also overwhelming support from respondents for the guidance remaining high-level and not becoming more prescriptive. It was felt that the comparative lack of prescription was an important factor in the success of the guidance, as it required boards to engage with issues of risk management and internal control. To quote another listed company, *“business is about balancing risks with potential returns, and the guidance must recognise the importance of sound management judgements in evaluating the risk-return trade-off. A more prescriptive approach could disadvantage shareholders by discouraging management from taking informed judgements”*.
- 3.7. This is consistent with comments from investors. The Investment Management Association (IMA) commented that the principles-based approach *“allows companies flexibility in applying the guidance and addressing their own circumstances and risks. A more prescriptive approach could engender a box-ticking, mechanistic approach to ensure compliance with the detail of the guidance rather than allowing companies to produce meaningful reports tailored to their own circumstances”*. The Association of British Insurers (ABI) stated that *“we strongly believe [the guidance’s] usefulness would be diminished by a prescriptive approach, which led further down the road of boilerplate disclosure and a focus by directors on compliance rather than substantive assessment and management of risk”*.
- 3.8. Companies that responded to the consultation exercise overwhelmingly supported retention of the principles-based approach as it enabled them to apply the guidance in a way that was compatible with their existing internal assurance frameworks, and for the internal control system to evolve over time as the risks faced by the company changed. This flexibility had also made it easier for the guidance to be adopted in different sectors and industries.
- 3.9. This support for a principles-based rather than rules-based approach in part reflects familiarity with, and confidence in, the UK’s overall approach to corporate governance. In a survey of UK and US investors carried out by the Institute of Chartered Accountants in England & Wales (ICAEW) in 2004<sup>3</sup>, the principles versus rules approach was cited more frequently than any other reason by respondents who expressed more confidence in UK rather than US audited financial information.
- 3.10. Respondents to the consultation exercise made many suggestions for possible changes to the guidance. The majority of these fell into one of the following categories:
  - definitions of terminology used in risk management and internal control, such as ‘risk appetite’ or ‘significant risk’;
  - more detailed guidance on the respective roles of the board, management, audit and risk committees, risk managers and internal auditors;
  - more detailed guidance on particular aspects of the internal control system;
  - more detailed guidance on how to review the effectiveness of the internal control system;

---

<sup>2</sup> ‘Disarming the Value Killers: A Risk Management Study’, Deloitte, 2005

<sup>3</sup> ‘Investors’ confidence in audited information – Wave 2’, The Institute of Chartered Accountants in England & Wales, December 2004

- examples of best practice techniques that could be used to apply the guidance;
- references to types of risk not currently referred to in the guidance, and/or more detailed guidance on controls for managing specific types of risk;
- amendments to reflect or refer to other, more detailed risk management frameworks, such as the COSO Enterprise Risk Management framework or the Institute of Risk Management's Risk Management Standard; and
- additions to the existing appendix, or new appendices.

## Analysis and recommendations

- 3.11. In view of the unanimous support from respondents for the Turnbull guidance continuing to cover all internal controls, and the anecdotal evidence that this has enabled companies to focus their attention on the key risks facing the company, **the Review Group proposes that the guidance should continue to cover all internal controls.**
- 3.12. The Review Group also agrees with the overwhelming majority of respondents that the principles-based approach of the guidance has been a considerable asset as it has enabled companies to apply the guidance intelligently and appropriately, and should therefore be retained. **The Review Group proposes that no changes should be made to the guidance that would have the effect of restricting a company's ability to apply the guidance in a manner suitable to its own particular circumstances.**
- 3.13. The Review Group recognises that companies will have implemented the Turnbull guidance to different degrees, but does not believe it is sensible to think in terms of a 'minimum standard' of implementation. Rather it is necessary to think in terms of what is appropriate for the company – what is appropriate for a small listed company operating in a single market may not be appropriate for a large conglomerate with operations around the world, and vice versa. The sheer variety of circumstances makes it unrealistic to go beyond the sort of high-level principles contained in the Turnbull guidance and attempt to define in guidance what would be appropriate in each case.
- 3.14. The Review Group is not persuaded that specifying a minimum implementation standard in guidance would necessarily have the effect of improving the overall quality of internal controls. Not only is there evidence that the Turnbull guidance prompted significant improvements in business practice with relatively little prescription, but in the view of many people those improvements were achieved precisely because of the lack of prescription.
- 3.15. A greater degree of prescription might lead to an increased perception that the guidance was a compliance exercise. This would adversely affect the effectiveness of the guidance and the balance of costs and benefits as perceived by companies, particularly smaller listed companies, and it may also lead some boards to provide less input to the process. 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. In the words of one respondent to the Review Group's consultation paper,

*“a more prescriptive approach would be more likely to lead to implementation difficulties and higher costs for some companies and, therefore, be less effective on balance. It might also be regarded more as a regulatory exercise, which would be in direct conflict with the original objectives of the Turnbull guidance”.*

- 3.16. The Review Group believes that a key factor in maintaining or improving a company’s ability to generate shareholder value and safeguard its assets is regular reappraisal by the company of the way in which it is applying the Turnbull guidance. One of the objectives of the original guidance was that it should “remain relevant over time in the continually evolving business environment”.
- 3.17. The Review Group considers that the onus is on the boards and management of companies to make continuous use of the guidance and not to view implementation as a one-off exercise. As noted in paragraph 2.9, there was a concern among some respondents that not all companies were doing so. In its response, the Institute of Risk Management observed that in some companies *“momentum on risk reporting and control had lost the initial impetus that was evident when the Combined Code and the Turnbull guidance was new, and many companies have reached a ‘comfort zone’ of reviewing the same ‘Top 10’ risks without questioning whether these remained so, or whether they had been accurately aligned with the key business objectives”.*
- 3.18. **The Review Group believes that boards should be given further encouragement to review on a continuing basis their application of the Turnbull guidance. It proposes to do so through a new preface to the guidance.**

### **Specific changes to the guidance**

- 3.19. In considering suggestions from respondents for substantive changes to the guidance itself, the Review Group applied four tests in addition to those identified in paragraph 3.2. These were:
- Does the proposed change address an issue that is not already substantially covered by the existing guidance?
  - Is a change to the guidance the most appropriate way to address the issue concerned?
  - Would any proposed change materially improve internal control and risk management at a reasonable cost?
  - Would any proposed change restrict a company’s ability to apply the guidance in a manner suitable to its own particular circumstances?
- 3.20. Having applied these tests, the Review Group considered that changes to the guidance were not justified in relation to the suggestions summarised in paragraph 3.10. For example:
- providing more detailed guidance on the respective roles of the board, management and the audit or risk committee would reduce the company’s ability to design its internal control system in a way that integrates with its existing assurance framework; and

- amending the appendix to reflect the COSO Enterprise Risk Management framework might appear to signal a need for overhauls in practice where none was intended or considered necessary.

3.21. The Review Group therefore does not propose to adopt the suggestions summarised in paragraph 3.10. It considers that if companies have a genuine need for further guidance on particular issues it should be met through other means, rather than reduce the perceived benefits of the existing guidance by making it more detailed and prescriptive. The Review Group believes that it is for the market to respond to demand for good practice guidance.

3.22. The Review Group proposes that the guidance should be amended to:

- **reinforce the message that the guidance is intended to reflect sound business practice as well as help companies comply with the internal control requirements of the Combined Code by re-ordering the introduction to the guidance.** The updated introduction would start by explaining the importance of risk management and internal control and the objectives of the guidance, before setting out the requirements of the Combined Code;
- **reflect changes in the Combined Code and Listing Rules.** The Combined Code and Listing Rules have both been revised since the guidance was first issued, and the references to both in the guidance need to be updated;
- **require the board to exercise reasonable care, skill and diligence when forming a view on the effectiveness of the internal control system to reflect the proposed statement of directors' duties in the draft Company Law Reform Bill, rather than forming a view "after due and careful enquiry".** This change is designed to make the guidance consistent with the proposed statement of directors' duties in the draft Company Law Reform Bill, which states that "*a director of a company... must exercise reasonable care, skill and diligence*"<sup>4</sup>. This will eliminate potential confusion about whether the board's consideration of internal control needs to be more or less rigorous than in other areas of governance and corporate reporting;
- **remove the section relating to internal audit which is now dealt with in provision C.3.5 of the Combined Code, and which the FRC should incorporate into the Smith guidance on audit committees.** The original guidance was written to assist companies to comply with the 'internal control' section of the 1998 version of the Combined Code, which included a provision that companies which did not have an internal audit function should from time to time review the need for one. When the Combined Code was revised in 2003 following the Smith Report on the role of audit committees, this provision was removed and replaced with new provision C.3.5 of the Code which makes the audit committee of such companies responsible for reviewing the need for an internal audit function on an annual basis. In view of this change, the Review Group considers that it is no longer appropriate to include guidance on the need for an internal audit function within the Turnbull guidance and suggests that the FRC should instead incorporate it into the Smith guidance on audit committees; and
- **link the company's risk assessment to the OFR.** As explained in paragraph 4.33, the Review Group believes there should be no need for companies

---

<sup>4</sup> Draft clause B.5.1, 'Company Law Reform', Cm6456, HMSO, March 2005

that are already applying the Turnbull guidance to develop additional processes in order to comply with the requirement to identify principal risks of the OFR. The Review Group proposes a minor amendment to the appendix to the guidance explicitly to link the process of evaluating the risks to which the company is exposed to the OFR.

- 3.23. Proposed changes to paragraphs 35 to 41 of the existing guidance, which concerns the internal control statement, are dealt with in section 4.



## 4. The internal control statement

### Background

- 4.1. Disclosure is a key part of the UK approach to corporate governance. Its purpose is to ensure that shareholders have sufficient information to enable them to take a view on the governance of a company as a basis for exercising their rights and responsibilities, and to encourage boards and management to discharge their responsibilities with care.
- 4.2. UK listed companies are required under the Listing Rules to include in their annual report and accounts a statement setting out how the company has applied Principle C.2 of the Combined Code (that “the Board should maintain a sound system of internal control”), and reporting that it had carried out, at least annually, a review of the effectiveness of the internal control system in accordance with Provision C.2.1 of the Code. There is no requirement on companies to give a public assessment of the effectiveness of the internal control system as there is in the US in relation to internal control over financial reporting under Section 404(a) of the Sarbanes-Oxley Act 2002.
- 4.3. The Combined Code does not prescribe a format for statements on how the company has applied the Code. Paragraphs 35 to 41 of the existing Turnbull guidance recommend certain minimum disclosures, and encourage boards to provide additional information to assist shareholders’ understanding of the company’s risk management processes and system of internal control.
- 4.4. The Review Group considered two issues:
  - What should companies be required to disclose in relation to the effectiveness review?; and
  - What other information should companies be encouraged to include in their internal control statement?

### Evidence

- 4.5. The evidence obtained on the value and impact of existing disclosure requirements, and views on whether changes should be made, is set out in more detail in section 3 of the evidence paper.

### The impact on companies

- 4.6. Anecdotal evidence from the consultation exercise suggests that the requirement to disclose information about the internal control system and confirm that a review has been carried out at least annually 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. This view is shared by the ABI, which said in its response that “*we believe that the requirement to disclose has caused boards to think more deeply about the issues and take steps to improve risk management*”, and is consistent with the results of the MORI surveys referred to in paragraph 2.5.

- 4.7. There was no consensus among companies about whether more informative internal control statements might benefit a company by improving the market's perceptions of the way in which it managed risk. Some respondents felt that there may be a commercial advantage in doing so, but others were concerned that they should not be required to disclose information that they considered commercially sensitive. Many did not believe that investors differentiated significantly in a positive way between companies on the basis of the perceived strength of their internal controls. Over 80% of the company directors interviewed by MORI who attended meetings with investors said that internal control matters were rarely or never raised in those meetings. This view was also expressed by many of the companies that responded to the consultation exercise, but it conflicts with the results of the survey of investors carried out by MORI.

### The value to investors

- 4.8. 88% of the investors interviewed by MORI for this review said that risk management and internal control is a very or fairly important factor when they are making judgements about a company.
- 4.9. What is less clear is the relative value that investors place on the internal control statement in the company's annual report in coming to an overall judgement about a company's risk management. In their responses to the consultation exercise, most investors said that they found many statements to be uninformative and 'boilerplate'. It appears that currently the main value of the internal control statement to investors is as a 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"*.
- 4.10. Institutional investors appear to use means other than reliance on the statement to reach a judgement on the quality of a company's internal controls. The IMA stated *"our members tend to rely on their discussions with a company's management, customers and suppliers as well as an analysis of results"*. This appears to be borne out to a certain extent by the MORI survey of investors – as noted in paragraph 4.8 above, 88% said that the quality of risk management and internal control was an important factor when reaching a judgement about a company, whereas 68% felt that the internal control statement was in itself important. However, this is still a high figure.
- 4.11. It is not clear to what extent the comparative value to investors of the internal control statement would increase were disclosures seen as more informative. To quote the IMA again, *"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"*.
- 4.12. That said, many of the investors that responded to the consultation exercise felt that their judgements would be aided by concise but informative disclosures that were specific to the company. In particular investors said that they would welcome more information about how the board assesses and manages the key risks facing the company. It was recognised that this demand should be met at least in part by the requirement for companies to comment on the directors' approach to the principal risks facing the company in the new OFR.

## Section 404 of the Sarbanes-Oxley Act

- 4.13. The review of the Turnbull guidance has been taking place during a period when there has been considerable debate over the implementation of Section 404 of the US Sarbanes-Oxley Act 2002. UK companies registered with the US Securities and Exchange Commission (SEC) will be required to comply with the disclosure requirements of Section 404 from July 2006. These include:
- a requirement for the company's management to publish in the annual report an assessment of the effectiveness of the company's internal control over financial reporting; and
  - a requirement for the external auditors to issue an attestation report on management's assessment.
- 4.14. Further requirements have been set out in the SEC's rules on the application of Section 404, and the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2 on the role of the external auditor.
- 4.15. Unlike the Turnbull guidance, Section 404 is concerned only with internal control over financial reporting.
- 4.16. Views on the impact of Section 404 to date differ. At a roundtable on implementation of internal control reporting provisions held by the SEC in April 2005, some panelists identified benefits with respect to financial reporting that included:
- 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.
- 4.17. The Review Group is not aware of any evidence which enables a comparison to be made of the general standard of internal controls within US and UK listed companies. However, many respondents to the consultation exercise considered that similar benefits had also been delivered by the Turnbull guidance, but across a broader range of activities.
- 4.18. There appears to be a general acceptance that the initial implementation costs of Section 404 have been considerably higher than anticipated and, in the view of some commentators, disproportionate to the benefits. It is not clear to what extent the costs incurred by companies during the first year of implementation will prove to be one-off or recurring costs. In May 2005 the SEC and PCAOB both issued further guidance intended to address some of the difficulties that had been experienced in implementing Section 404 in the first year.
- 4.19. One of the important tests of the impact of Section 404 will be whether investors in the US and rating agencies use the disclosures as a basis for differentiating between companies. At present it is too early to say whether that will prove to be the case.
- 4.20. In its evidence gathering consultation paper, the Review Group invited views on whether Section 404 type disclosure requirements should be introduced in

the UK. Almost all companies, and most investors, opposed the introduction of such a requirement. The primary reason was the perceived costs without any proportionate benefit, and there was concern that costs would be even higher than in the US as the Turnbull guidance covers all internal controls, not just internal control over financial reporting. The other main arguments against a public effectiveness statement were:

- the concept of effectiveness is not a meaningful one for public reporting purposes when considering non-financial reporting issues, where the company's response to risk is determined by its 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;
- 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.

4.21. Views on whether the external auditor should be required to make an attestation report are summarised in section 5.

## Analysis and recommendations

4.22. The Review Group takes the view that any changes to disclosure requirements must be proportionate. Investors told us that, while they would find more informative disclosures helpful, the internal control statement was not the only, or even the most significant, factor they took into consideration when assessing a company's risk management and internal controls. That being the case, the Review Group took the view that it would not be appropriate to impose potentially onerous requirements on companies if the resulting statements were of only limited value to shareholders. The Review Group also notes that the new OFR should meet at least part of the demand from investors for more disclosure on principal risks.

4.23. The Review Group does not recommend any changes to the disclosure requirements concerning internal control in the Combined Code. The Review Group has, however, considered whether the Turnbull guidance should be amended to encourage companies to provide their shareholders with more of the sort of information that they would find helpful.

### **The outcome of the company's review of the internal control system**

4.24. **The Review Group considers that it is not appropriate to require boards to make a statement in the annual report and accounts on the effectiveness of the company's internal control system.**

4.25. The main concerns associated with adopting such requirements are summarised in paragraph 4.20, and are largely shared by the Review Group. The Review Group does not consider that the concept of effectiveness would

be meaningful for public reporting purposes when considering many operational risks, for example, where the company's response is determined by its risk appetite and cannot be mandated by reference to some objective standard. In addition, in the Review Group's opinion, a requirement for a statement that processes are effective would be bound to lead to expensive and detailed testing and verification work. The Review Group did not consider the benefit of such a statement to investors would be sufficient to recommend that it should be required, and was concerned that it might result in a focus on compliance rather than substantive assessment and management of risk, undermining what was seen as one of the main strengths of the Turnbull approach.

- 4.26. One argument put forward in favour of requiring companies to make a statement on the effectiveness of internal controls over financial reporting was that in time investors will begin to differentiate between those companies that disclose under Section 404 and those that do not, to the disadvantage of the latter, as compliance with Section 404 will come to be seen as representing a higher standard of internal control. It is possible that may prove to be the case in the future, but judging by the majority of responses from investors is not the case at present. If the market does develop in that way, then companies have the option voluntarily to make a statement on the effectiveness of their controls if they consider that to be in their overall interests. The Review Group does not believe that assumptions about future market developments are a sufficient basis for imposing new requirements on companies.
- 4.27. That said, the Review Group accepts that the current requirement in Provision C.2.1 of the Combined Code simply to state that a review of the internal control system has been carried out, without making any comment at all on the outcome of the review, does invite a number of questions. The Review Group therefore considered whether there were ways in which the disclosure requirements might be changed to provide further reassurance to investors and further encouragement to boards to ensure that a thorough review was carried out, but without raising the concerns associated with a public statement on the effectiveness of the internal control system or imposing costs on companies that were disproportionate to the value that investors derive from the internal control statement.
- 4.28. One suggestion arising from the consultation exercise was that companies should be required to provide details of material or significant changes made to the internal control system as a result of the review. The Review Group considered that this could, in effect, be asking companies to disclose any material weaknesses identified with consequences for market perceptions, and this would raise concerns among companies. It would also require a definition of the term 'material' or 'significant' in order to avoid the possibility of lengthy disclosures and to promote consistency of interpretation. The Review Group does not consider it would be appropriate to define these terms in the guidance, as what is material or significant will depend on the company.
- 4.29. **The Review Group instead proposes that the guidance should be amended to require boards to confirm that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from the their review of the effectiveness of the internal control system. Paragraph 31 of the**

existing 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. The Review Group acknowledges that this may become a boilerplate disclosure, but believes that by bringing it within the scope of the statement made by the board it may provide investors with some additional reassurance that the outcome of the process had focused on action as well as reporting.

## The Operating and Financial Review

- 4.30. Quoted companies in the UK are required to prepare an OFR<sup>5</sup> for financial years beginning on or after 1 April 2005. The OFR will be included in the company's annual report and accounts, and compliance with the regulations will be enforced by the Financial Reporting Review Panel (FRRP) for financial years beginning on or after 1 April 2006.
- 4.31. The OFR must include, inter alia, information on the principal risks and uncertainties that may affect the company's long-term value. The Accounting Standards Board (ASB) published the reporting standard for the OFR in May 2005<sup>6</sup>. The reporting standard states that "the OFR shall include a description of the principal risks and uncertainties facing the entity together with a commentary on the directors' approach to them". Disclosures made in the OFR should therefore go a long way to meeting investors' desire for more information about the company's key risks, as identified in the responses to the consultation on the Turnbull guidance.
- 4.32. The approach taken by the ASB in preparing the relevant part of the reporting standard is consistent with that of the Turnbull guidance. The standard states, for example, that "the principal risks and uncertainties facing entities will vary according to the nature of the business" and that "directors will need to consider the full range of business risks". In the implementation guidance that accompanies the standard, the ASB advises that the key performance indicators reported in the OFR will be those that directors already use to monitor their principal risks.
- 4.33. The Review Group considers that a company that has followed the Turnbull guidance should already have identified the principal risks facing it and put in place internal monitoring and reporting processes. **There should be no need for companies that are already applying the Turnbull guidance to develop additional processes in order to comply with the requirement to identify principal risks in the OFR.**
- 4.34. There is clearly some potential overlap between the commentary on principal risks in the OFR with the disclosures on the company's internal control system required under the Combined Code. In its consultation paper the Review Group invited views on how this overlap might be managed.
- 4.35. It was clear from the responses that there was a desire for the two statements to be consistent, and for duplication that unnecessarily added to the length of the annual report to be avoided. There was however no consensus as to

---

<sup>5</sup> Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (SI 2005/1011)

<sup>6</sup> 'Reporting Standard 1: Operating and Financial Review', Accounting Standards Board, May 2005



how these objectives should be met. Some respondents felt that there was an obvious distinction between information on specific business risks in the OFR and high-level information on the company's internal control framework in the internal control statement required by the Combined Code; for others the distinction was less clear. Some respondents argued that the internal control statement should be incorporated in the OFR, although it should be noted that doing so would change the status of the internal control statement from a 'comply or explain' disclosure made to shareholders to a mandatory disclosure that could be enforced by the FRRP and subject to legal sanctions.

- 4.36. In the absence of any consensus on the issue, and in keeping with its belief that flexibility in application of the guidance has been a major factor in its success, the Review Group does not believe it would be appropriate to prescribe in the Turnbull guidance how the potential overlap should be managed. **But the Review Group encourages companies to ensure the OFR and the internal control statement are complementary** – as noted in paragraph 4.33, this should not be difficult where companies are already applying the Turnbull guidance – and to provide a cross-reference from the internal control statement to the OFR to assist investors.

### **Other information to be contained in the internal control statement**

- 4.37. Most investors who responded to the consultation exercise said that they would welcome more informative disclosures. With the exception of more details of the key risks facing the company, which should be provided through the new OFR, there was no consensus on what information they would like to see included. Most investors appear to value company-specific disclosures.
- 4.38. The Review Group has considered how the guidance might encourage such disclosures, but has concluded that it would not be appropriate to impose detailed requirements for the same reason that it would not be appropriate to be prescriptive about how the guidance should be implemented, particularly in the absence of consensus. If what is wanted is company-specific disclosure then companies have to be able to exercise judgement about what information to include. The CBI suggested that if shareholders felt that the public disclosures made by individual companies could be made more informative, boards might welcome more direct feedback on the issue, rather than additional standardised disclosure requirements.
- 4.39. **The Review Group proposes that the revised guidance should make it clear that the annual report and accounts should include such information as the board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control.**
- 4.40. **The Review Group encourages boards to look on the internal control statement as an opportunity to communicate to shareholders how they manage risk effectively.**

## EU developments

- 4.41. At the same time as the Review Group has been considering what companies should disclose under the Combined Code, EU Member States and the European Parliament have been discussing proposals from the European Commission to introduce requirements in the 4th and 7th Company Law Directives relating to the disclosure of information about listed companies' internal control and risk management systems. The EU legislative process is not yet complete, and it is possible that the Commission's proposals may be subject to further change.
- 4.42. Under the current proposals, listed companies would be required to include in their annual report and accounts "a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process". Groups would in addition be required to describe the main features of the internal controls relating to the production of the consolidated accounts.
- 4.43. The Review Group has been advised that there is nothing in the revised Directives as currently drafted which precludes Member States from applying broader requirements in respect of internal controls. The Review Group believes it will be important to ensure that this remains the case and that the UK is able to continue to follow the risk-based approach of the Turnbull guidance. This review has found a clear consensus among companies and investors that it is important for companies to consider and manage all significant risks, and that a narrower focus on financial reporting controls would be a retrograde step.
- 4.44. The Review Group hopes that it will prove possible to implement any new EU requirements in such a way that companies will not need to make a separate, new disclosure in addition to the internal control statement required under the Combined Code. If that should not prove possible, the Government should aim to keep any additional requirements to a minimum.



## 5. The role of the external auditor

### Background

- 5.1. External auditors are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system (provision C.2.1 of the Combined Code). Auditing Practices Board (APB) guidance<sup>7</sup> 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.
- 5.2. In relation to the recommendation in the Turnbull guidance that the company should disclose the process applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts, the APB guidance states that the auditor should discuss with the directors the steps they have taken to determine what significant problems are disclosed in the annual report and accounts and assess whether the internal control statement appropriately reflects those processes. The auditor is not required to assess whether the processes described by the directors will, in fact, remedy the problem described in the annual report and accounts.
- 5.3. 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 company's internal control system. As noted in paragraph 4.15, 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.
- 5.4. In reviewing the company's internal control statement the external auditor will also draw on the knowledge of the company that they have obtained during the audit of the financial statements. Under the new International Standard on Auditing (UK and Ireland) ISA 315, external auditors are required to obtain an understanding of internal control relevant to the audit.
- 5.5. The Review Group considered whether the current responsibilities of the external auditors provided value for the board and shareholders, and whether there was a case for those responsibilities to be added to or otherwise changed.

### Evidence, analysis and recommendations

- 5.6. The evidence obtained on the current and possible responsibilities of external auditors is set out in more detail in section 4 of the evidence paper.
- 5.7. Responses to the consultation exercise were consistent on this issue, with similar views being held by business, investors and the accountancy profession. The general view was that the activities of the external auditor in reviewing the company's internal control statement, while limited, provide

---

<sup>7</sup> 'The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority' (Bulletin 2004/3), Auditing Practices Board, November 2004

additional 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.

- 5.8. The existing powers and remit of the external auditors were considered sufficient and there was virtually no support for the external auditor's role to be extended; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.
- 5.9. The main arguments against an expanded role were 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 evidence from the implementation of Section 404(b) of the Sarbanes-Oxley Act in the US suggested that there could be significant direct and indirect costs for the company if the external auditor were required to attest as to the effectiveness of internal controls, particularly as the range of controls covered by the Combined Code and Turnbull guidance was broader than those covered by Section 404.
- 5.10. The Review Group agrees with this analysis. There is virtually no demand from investors or companies for an increased role for external auditors, which supports the conclusion that an increased role would not be justified on a cost-benefit basis. In addition, the Review Group considers it would be inappropriate to require the external auditor to give assurances in respect of the effectiveness of the controls when it is recommending that the board should not be required to do so.
- 5.11. **The Review Group recommends that there should be no expansion of the external auditors' responsibilities in relation to the company's internal control statement.**
- 5.12. The APB will wish to consider whether its existing guidance would need to be revised to reflect the proposals on disclosure set out in section 4 of this consultation paper. In making its recommendations, the Review Group intended that the nature of the auditor's responsibilities should remain the same. In the view of the Review Group the APB's existing guidance, summarised in paragraphs 5.1 and 5.2, would provide an appropriate framework, and would be consistent with the views expressed by respondents to this review.

# Appendix A1

## Draft revised guidance

### Internal Control

#### Draft Revised Guidance for Directors on the Combined Code

June 2005

#### Contents

	Paragraph number(s)
<b>Preface</b>	
<b>Introduction</b>	
The importance of internal control and risk management	1-4
Objectives of the guidance	5-6
Internal control requirements of the Combined Code	7-12
Groups of companies	13
The Appendix	14
<b>Maintaining a sound system of internal control</b>	
Responsibilities	15-18
Elements of a sound system of internal control	19-23
<b>Reviewing the effectiveness of internal control</b>	
Responsibilities	24-25
The process for reviewing effectiveness	26-32
The board's statement on internal control	33-38
<b>Appendix</b>	
Assessing the effectiveness of the company's risk and control processes	

## Draft revised guidance

### Preface

*Internal Control: Guidance for Directors on the Combined Code* (The Turnbull guidance) was first issued in 1999.

In 2004, the Financial Reporting Council established the Turnbull Review Group to consider the impact of the guidance and the related disclosures and to determine whether the guidance needed to be updated.

In reviewing the impact of the guidance, our consultations revealed that it has very successfully gone a long way to meeting its original objectives. Boards and investors alike indicated that the guidance has contributed to a marked improvement in the overall standard of risk management and internal control since 1999.

Notably, the evidence gathered by the Review Group demonstrated that respondents considered that the substantial improvements in internal control instigated by application of the Turnbull guidance have been achieved without the need for detailed prescription as to how to implement the guidance. The principles-based approach has required boards to think seriously about control issues and enabled them to apply the principles in a way that appropriately dealt with the circumstances of their business. The evidence also supported the proposition that the companies which have derived most benefit from application of the guidance were those whose boards saw embedded risk management and internal control as an integral part of running the business.

Accordingly, the Review Group strongly endorsed retention of the flexible, principles-based approach of the original guidance and has made only a small number of changes.

This however does not mean that there is nothing new for boards to do or that some companies could not make more effective use of the guidance. Establishing an effective system of internal control is not a one-off exercise. No such system remains effective unless it develops to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. The Review Group reiterates the view of the vast majority of respondents in emphasising the value of embedding risk management and internal control systems within business processes. It is the board's responsibility to make sure this happens.

Boards should also review the communication opportunity of the internal control statement in the annual report. Investors consider the board's attitude towards risk management and internal control to be an important factor when making investment decisions about a company. Taken together with the Operating and Financial Review, the internal control statement provides an opportunity for the board to explain to shareholders what are the specific risk and control issues facing the company, how the company maintains a framework of internal controls to address these issues and how the board has reviewed the effectiveness of that framework.

It is in this spirit that directors need to exercise their responsibility to review on a continuing basis their application of the revised guidance.

**Turnbull Review Group**  
[date to be inserted]

## Introduction

### The importance of internal control and risk management

- 1 A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives. A sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets.
- 2 Internal control (as referred to in paragraph 19) facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.
- 3 Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control. They help ensure that the company is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.
- 4 A company's objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

### Objectives of the guidance

- 5 This guidance is intended to:
  - reflect sound business practice whereby internal control is 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 it in a manner which takes account of its particular circumstances.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Combined Code relating to internal control and reporting to shareholders thereon.

- 6 The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

## Draft revised guidance

### Internal Control requirements of the Combined Code

- 7 **Principle C.2** of the Code states that ‘The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets’.
- 8 **Provision C.2.1** states that ‘The directors 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’.
- 9 Paragraph 9.8.6 of the UK Listing Authority’s Listing Rules states that in the case of a listed company incorporated in the United Kingdom, the following items must be included in its annual report and accounts:
  - a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;
  - a statement as to whether the listed company has:
    - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
    - not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:
      - (i) those provisions, if any, it has not complied with;
      - (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
      - (iii) the company’s reasons for non-compliance.
- 10 The Preamble to the Code makes it clear that there is no prescribed form or content for the statement setting out how the various principles in the Code have been applied. The intention is that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances which have led to them adopting a particular approach.
- 11 The guidance in this document applies for accounting periods beginning on or after 1 January 2006, and should be followed by boards of listed companies in:
  - assessing how the company has applied Code Principle C.2;
  - implementing the requirements of Code Provision C.2.1; and
  - reporting on these matters to shareholders in the annual report and accounts.

## Draft revised guidance

- 12 For the purposes of this guidance, internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls.

### Groups of companies

- 13 Throughout this guidance, where reference is made to ‘company’ it should be taken, where applicable, as referring to the group of which the reporting company is the parent company. For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole.

### The Appendix

- 14 The Appendix to this document contains questions which boards may wish to consider in applying this guidance.

## Maintaining a sound system of internal control

### Responsibilities

- 15 The board of directors is responsible for the company’s system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The board must further ensure that the system of internal control is effective in managing those risks in the manner which it has approved.
- 16 In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board’s deliberations should include consideration of the following factors:
- the nature and extent of the risks facing the company;
  - the extent and categories of risk which it regards as acceptable for the company to bear;
  - the likelihood of the risks concerned materialising;
  - the company’s ability to reduce the incidence and impact on the business of risks that do materialise; and
  - the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.
- 17 It is the role of management to implement board policies on risk and control. In fulfilling its responsibilities management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.
- 18 All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information, and authority to establish, operate

## Draft revised guidance

and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces.

### Elements of a sound system of internal control

- 19 An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:
- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;
  - help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation;
  - help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.
- 20 A company's system of internal control will reflect its control environment which encompasses its organisational structure. The system will include:
- control activities;
  - information and communications processes; and
  - processes for monitoring the continuing effectiveness of the system of internal control.
- 21 The system of internal control should:
- be embedded in the operations of the company and form part of its culture;
  - be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment; and
  - include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken.
- 22 A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.
- 23 A sound system of internal control therefore provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations.



### Reviewing the effectiveness of internal control

#### Responsibilities

- 24 Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board will need to form its own view on effectiveness exercising reasonable care, skill and diligence based on the information and assurances provided to it. Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so.
- 25 The role of board committees in the review process, including that of the audit committee, is for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces. To the extent that designated board committees carry out, on behalf of the board, tasks that are attributed in this guidance document to the board, the results of the relevant committees' work should be reported to, and considered by, the board which takes responsibility for the disclosures on internal control in the annual report and accounts.

#### The process for reviewing effectiveness

- 26 Effective monitoring on a continuous basis is an essential component of a sound system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered 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.
- 27 The board should define the process to be adopted for its review of the effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it will be provided with sound, appropriately documented, support for its statement on internal control in the company's annual report and accounts.
- 28 The reports from management to the board should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact that they have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the board on matters relating to risk and control.

## Draft revised guidance

- 29 When reviewing reports during the year, the board should:
- consider what are the significant risks and assess how they have been identified, evaluated and managed;
  - assess the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
  - consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
  - consider whether the findings indicate a need for more extensive monitoring of the system of internal control.
- 30 Additionally, the board should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the board has taken account 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.
- 31 The board's 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, and, where applicable, the work of its internal audit function and other providers of assurance;
  - the extent and frequency of the communication of the results of the monitoring to the board (or board committee(s)) which enables it to build up 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.
- 32 Should the board become aware at any time of a significant failing or weakness in internal control, it should determine how the failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

## Draft revised guidance

### The board's statement on internal control

- 33 The annual report and accounts should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control, and should not give a misleading impression.
- 34 In its narrative statement of how the company has applied Code Principle C.2, the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.
- 35 The disclosures relating to the application of Principle C.2 should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.
- 36 In relation to Code Provision C.2.1, the board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.
- 37 Where a board cannot make one or more of the disclosures in paragraphs 34 and 36, it should state this fact and provide an explanation. The Listing Rules require the board to disclose if it has failed to conduct a review of the effectiveness of the company's system of internal control.
- 38 Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed.

## Appendix

### Assessing the effectiveness of the company's risk and control processes

Some questions which the board may wish to consider and discuss with management when regularly reviewing reports on internal control and when carrying out its annual assessment are set out below. The questions are not intended to be exhaustive and will need to be tailored to the particular circumstances of the company.

This Appendix should be read in conjunction with the guidance set out in this document.

#### Risk assessment

- Does the company have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? These are likely to include the principal risks identified in the Operating and Financial Review.
- Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

#### Control environment and control activities

- Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?
- Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
- Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?
- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?
- Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection; security of tangible and intangible assets; business continuity issues; expenditure matters; accounting; and financial and other reporting.

## Draft revised guidance

- Do people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

### Information and communication

- Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision-making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes etc.
- Are information needs and related information systems reassessed as objectives and related risks change or as reporting deficiencies are identified?
- Are periodic reporting procedures, including half-yearly and annual reporting, effective in communicating a balanced and understandable account of the company's position and prospects?
- Are there established channels of communication for individuals to report suspected breaches of law or regulations or other improprieties?

### Monitoring

- Are there ongoing processes embedded within the company's overall business operations, and addressed by senior management, which monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews).
- Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?
- Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the board (or board committees) on the effectiveness of the ongoing monitoring processes on risk and control matters? This should include reporting any significant failings on a timely basis.
- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the company's reputation or financial position.

# Appendix A2

## Draft revised guidance (with proposed changes highlighted)

### Internal Control

#### Draft Revised Guidance for Directors on the Combined Code

June 2005 ~~September 1999~~

### Contents

	Paragraph number(s)
<b>Preface</b>	
<b>Foreword</b>	
<b>Introduction</b>	
The importance of internal control and risk management	1-4
Objectives of the guidance	5-6
Internal control requirements of the Combined Code	7-12
Groups of companies	13
The Appendix	14
<b>Maintaining a sound system of internal control</b>	
Responsibilities	15-18
Elements of a sound system of internal control	19-23
<b>Reviewing the effectiveness of internal control</b>	
Responsibilities	24-25
The process for reviewing effectiveness	26-32
The board's statement on internal control	33-38
<b>Internal Audit</b>	
<b>Appendix</b>	
Assessing the effectiveness of the company's risk and control processes	

# Draft revised guidance (with proposed changes highlighted)

## Preface

*Internal Control: Guidance for Directors on the Combined Code* (The Turnbull guidance) was first issued in 1999.

In 2004, the Financial Reporting Council established the Turnbull Review Group to consider the impact of the guidance and the related disclosures and to determine whether the guidance needed to be updated.

In reviewing the impact of the guidance, our consultations revealed that it has very successfully gone a long way to meeting its original objectives. Boards and investors alike indicated that the guidance has contributed to a marked improvement in the overall standard of risk management and internal control since 1999.

Notably, the evidence gathered by the Review Group demonstrated that respondents considered that the substantial improvements in internal control instigated by application of the Turnbull guidance have been achieved without the need for detailed prescription as to how to implement the guidance. The principles-based approach has required boards to think seriously about control issues and enabled them to apply the principles in a way that appropriately dealt with the circumstances of their business. The evidence also supported the proposition that the companies which have derived most benefit from application of the guidance were those whose boards saw embedded risk management and internal control as an integral part of running the business.

Accordingly, the Review Group strongly endorsed retention of the flexible, principles-based approach of the original guidance and has made only a small number of changes.

This however does not mean that there is nothing new for boards to do or that some companies could not make more effective use of the guidance. Establishing an effective system of internal control is not a one-off exercise. No such system remains effective unless it develops to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. The Review Group reiterates the view of the vast majority of respondents in emphasising the value of embedding risk management and internal control systems within business processes. It is the board's responsibility to make sure this happens.

Boards should also review the communication opportunity of the internal control statement in the annual report. Investors consider the board's attitude towards risk management and internal control to be an important factor when making investment decisions about a company. Taken together with the Operating and Financial Review, the internal control statement provides an opportunity for the board to explain to shareholders what are the specific risk and control issues facing the company, how the company maintains a framework of internal controls to address these issues and how the board has reviewed the effectiveness of that framework.

It is in this spirit that directors need to exercise their responsibility to review on a continuing basis their application of the revised guidance.

Turnbull Review Group  
[date to be inserted]

## Draft revised guidance (with proposed changes highlighted)

### Foreword

~~The UK Listing Authority of the London Stock Exchange welcomes the publication of *Internal Control: Guidance for Directors on the Combined Code*, published by the Internal Control Working Party of the Institute of Chartered Accountants in England and Wales. The work involved in preparing this guidance for directors of UK incorporated listed companies in respect of Principle D.2 of the Combined Code, and its associated Provisions D.2.1 and D.2.2, has been greatly appreciated.~~

~~The Working Party's guidance is consistent with both the requirements of the Combined Code and of the related Listing Rule disclosure requirements, and makes clear to boards of directors of listed companies what is expected of them. The Listing Authority considers compliance with the guidance to constitute compliance with Combined Code provisions D.2.1 and D.2.2 and provide appropriate narrative disclosure of how Code principle D.2 has been applied.~~

~~Once the guidance has been adopted in full by a company the guidance on Internal Control and Financial Reporting (the Rutteman guidance) will have been superseded and full compliance with the Combined Code and Listing Rule disclosure requirements is possible.~~

~~Paul Geradine  
Head of Listing  
London Stock Exchange~~

~~September 1999~~



## Introduction

### The importance of internal control and risk management

- 1 40 A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives. A sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets.
- 2 44 Internal control (as referred to in paragraph 19) facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.
- 3 42 Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control. They help ensure that the company is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.
- 4 43 A company's objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

### Objectives of the guidance

- 5 8 This guidance is intended to:
- reflect sound business practice whereby internal control is 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 it in a manner which takes account of its particular circumstances.

The guidance requires directors to exercise judgement in reviewing how the company has implemented the requirements of the **Combined** Code relating to internal control and reporting to shareholders thereon.

- 6 9 The guidance is based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements.

## Draft revised guidance (with proposed changes highlighted)

### Internal Control requirements of the Combined Code

Former ~~1~~ ~~When the Combined Code of the Committee on Corporate Governance (the Code) was published, the Institute of Chartered Accountants in England & Wales agreed with the London Stock Exchange that it would provide guidance to assist listed companies to implement the requirements in the Code relating to internal control.~~

7.2 Principle C.2 of the Code states that ‘The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets’.

8.3 Provision C.2.1 states that ‘The directors 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**’.

Former ~~4~~ ~~Provision D.2.2 states that ‘Companies which do not have an internal audit function should from time to time review the need for one’.~~

9.5 Paragraph ~~42.43A~~ 9.8.6 of the UK Listing Authority’s ~~London Stock Exchange~~ Listing Rules states that in the case of a **listed** company incorporated in the United Kingdom, the following **additional** items must be included in its annual report and accounts:

- a **narrative** statement of how the **listed company** ~~it~~ has applied the principles set out in Section 1 of the Combined Code, **in a manner that would providing explanation enables its** shareholders to evaluate how the principles have been applied;
- a statement as to whether **the listed company** has:
  - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
  - not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:
    - (i) those provisions, if any, it has not complied with;
    - (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
    - (iii) the company’s reasons for non-compliance.

~~a statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.~~

## Draft revised guidance (with proposed changes highlighted)

- 10 ~~6~~ The Preamble to the Code, ~~which is appended to the Listing Rules~~, makes it clear that there is no prescribed form or content for the statement setting out how the various principles in the Code have been applied. The intention is that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances which have led to them adopting a particular approach.
- 11 ~~7~~ The guidance in this document **applies for accounting periods beginning on or after 1 January 2006, and** should be followed by boards of listed companies in:
- assessing how the company has applied Code Principle ~~CD.2~~;
  - implementing the requirements of Code Provisions ~~CD.2.1; and D.2.2; and~~
  - reporting on these matters to shareholders in the annual report and accounts.
- 12 For the purposes of this guidance, internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls. *[part of former paragraph 28]*

### Groups of companies

- 13 ~~44~~ Throughout this guidance, where reference is made to ‘company’ it should be taken, where applicable, as referring to the group of which the reporting company is the parent company. For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole.

### The Appendix

- 14 ~~45~~ The Appendix to this document contains questions which boards may wish to consider in applying this guidance.

## Maintaining a sound system of internal control

### Responsibilities

- 15 ~~46~~ The board of directors is responsible for the company’s system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The board must further ensure that the system of internal control is effective in managing those risks in the manner which it has approved.
- 16 ~~47~~ In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board’s deliberations should include consideration of the following factors:
- the nature and extent of the risks facing the company;
  - the extent and categories of risk which it regards as acceptable for the company to bear;

## Draft revised guidance (with proposed changes highlighted)

- the likelihood of the risks concerned materialising;
- the company's ability to reduce the incidence and impact on the business of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

**17 18** It is the role of management to implement board policies on risk and control. In fulfilling its responsibilities management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.

**18 19** All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information, and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces.

### Elements of a sound system of internal control

**19 20** An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;
- help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation;
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

**20 21** A company's system of internal control will reflect its control environment which encompasses its organisational structure. The system will include:

- control activities;
- information and communications processes; and
- processes for monitoring the continuing effectiveness of the system of internal control.

**21 22** The system of internal control should:

- be embedded in the operations of the company and form part of its culture;
- be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment; and
- include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken.

## Draft revised guidance (with proposed changes highlighted)

- 22 ~~23~~ A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.
- 23 ~~24~~ A sound system of internal control therefore provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations.

## Reviewing the effectiveness of internal control

### Responsibilities

- 24 ~~25~~ Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board will need to form its own view on effectiveness **exercising reasonable care, skill after due** and **diligence careful enquiry** based on the information and assurances provided to it. Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so. *[This change is proposed to make the wording consistent with that of the proposed Company Law Reform Bill.]*
- 25 ~~26~~ The role of board committees in the review process, including that of the audit committee, is for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces. To the extent that designated board committees carry out, on behalf of the board, tasks that are attributed in this guidance document to the board, the results of the relevant committees' work should be reported to, and considered by, the board which takes responsibility for the disclosures on internal control in the annual report and accounts.

### The process for reviewing effectiveness

- 26 ~~27~~ Effective monitoring on a continuous basis is an essential component of a sound system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered 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.

Former 28 ~~The reference to 'all controls' in Code Provision D.2.1 should not be taken to mean that the effectiveness of every internal control (including controls designed to manage immaterial risks) should be subject to review by the~~

## Draft revised guidance (with proposed changes highlighted)

~~board. Rather it means that, for the purposes of this guidance, internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls. [The first part of this former paragraph has been removed as the 2003 Combined Code now refers to ‘material controls’. The remainder is in new paragraph 12.]~~

- 27 ~~29~~ The board should define the process to be adopted for its review of the effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it will be provided with sound, appropriately documented, support for its statement on internal control in the company’s annual report and accounts.
- 28 ~~30~~ The reports from management to the board should, in relation to the areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact that they have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the board on matters relating to risk and control.
- 29 ~~31~~ When reviewing reports during the year, the board should:
- consider what are the significant risks and assess how they have been identified, evaluated and managed;
  - assess the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
  - consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
  - consider whether the findings indicate a need for more extensive monitoring of the system of internal control.
- 30 ~~32~~ Additionally, the board should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the board has taken account 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.
- 31 ~~33~~ The board’s 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, and, where applicable, the work of its internal audit function and other providers of assurance;

## Draft revised guidance (with proposed changes highlighted)

- the extent and frequency of the communication of the results of the monitoring to the board (or board committee(s)) which enables it to build up 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.

**32 34** Should the board become aware at any time of a significant failing or weakness in internal control, it should determine how the failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

### The board's statement on internal control

**33** The annual report and accounts should include such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control, and should not give a misleading impression.

*[This replaces former paragraphs 36 and 40]*

**34 35** In its narrative statement of how the company has applied Code Principle CD.2, the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.

Former ~~The board may wish to provide additional information in the annual report to assist understanding of the company's risk management processes and system of internal control.~~  
**36**

**35 37** The disclosures relating to the application of Principle CD.2 should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

**36 38** In relation to Code Provision CD.2.1, the board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.



## Draft revised guidance (with proposed changes highlighted)

37 ~~39~~ Where a board cannot make one or more of the disclosures in paragraphs 34~~5~~ and 36~~8~~, it should state this fact and provide an explanation. The Listing Rules require the board to disclose if it has failed to conduct a review of the effectiveness of the company's system of internal control.

Former ~~The board should ensure that its disclosures provide meaningful, high level~~  
40 ~~information and do not give a misleading impression.~~

38 41 Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed.

### Internal audit

*[It is proposed that this section should be incorporated into the Smith guidance on audit committees. Under the 2003 Combined Code the audit committee is responsible for considering the need for an internal audit function.]*

42. ~~Provision D.2.2 of the Code states that companies which do not have an internal audit function should from time to time review the need for one.~~
43. ~~The need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the board may desire objective assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues.~~
44. ~~In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control is functioning as intended. In these circumstances, the board will need to assess whether such processes provide sufficient and objective assurance.~~
45. ~~When undertaking its assessment of the need for an internal audit function, the board should also consider whether there are any trends or current factors relevant to the company's activities, markets or other aspects of its external environment, that have increased, or are expected to increase, the risks faced by the company. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.~~
46. ~~The board of a company that does not have an internal audit function should assess the need for such a function annually having regard to the factors referred to in paragraphs 43 and 45 above. Where there is an internal audit function, the board should annually review its scope of work, authority and resources, again having regard to those factors.~~
47. ~~If the company does not have an internal audit function and the board has not reviewed the need for one, the Listing Rules require the board to disclose these facts.~~



## Appendix

### Assessing the effectiveness of the company's risk and control processes

Some questions which the board may wish to consider and discuss with management when regularly reviewing reports on internal control and when carrying out its annual assessment are set out below. The questions are not intended to be exhaustive and will need to be tailored to the particular circumstances of the company.

This Appendix should be read in conjunction with the guidance set out in this document.

#### Risk assessment

- Does the company have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? **These are likely to include the principal risks identified in the Operating and Financial Review.** (~~Significant risks may, for example, include those related to market, credit, liquidity, technological, legal, health, safety and environmental, reputation, and business probity issues.~~)
- Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

#### Control environment and control activities

- Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?
- Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
- Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?
- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?
- Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection; security of tangible and intangible assets; business continuity issues; expenditure matters; accounting; and financial and other reporting.

## Draft revised guidance (with proposed changes highlighted)

- Do people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

### Information and communication

- Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision-making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes etc.
- Are information needs and related information systems reassessed as objectives and related risks change or as reporting deficiencies are identified?
- Are periodic reporting procedures, including half-yearly and annual reporting, effective in communicating a balanced and understandable account of the company's position and prospects?
- Are there established channels of communication for individuals to report suspected breaches of law or regulations or other improprieties?

### Monitoring

- Are there ongoing processes embedded within the company's overall business operations, and addressed by senior management, which monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews).
- Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?
- Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the board (or board committees) on the effectiveness of the ongoing monitoring processes on risk and control matters? This should include reporting any significant failings on a timely basis.
- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the company's reputation or financial position.

# Appendix B

## The UK regulatory framework

1. The Turnbull guidance is part of a framework that comprises:
  - company and common law;
  - the Listing Rules;
  - the Combined Code on Corporate Governance; and
  - the Turnbull guidance.

### Company and common law

2. Directors have duties under common law and in statute.
3. Under common law, directors have fiduciary duties to the company that include duties relating to their stewardship of the company. Duties to the company include the duty of skill and care of the directors which, when operating and making decisions as a board, requires them to:
  - act in good faith in the best interests of the company;
  - use powers conferred on them for the proper purpose; and
  - exercise skill and reasonable care when acting in the company's interest.
4. In March 2005 the Government announced plans to codify in company law many of the directors' duties currently in common law. These are summarised in paragraphs 9 and 10 below.
5. Some specific duties of the directors of a company are already set out in legislation. Under the Companies Act 1985, for example, directors are required to prepare financial statements that give a 'true and fair' view and, subject to certain exemptions, those financial statements must be independently audited. Considerable care is thus required in the preparation of financial statements and deliberate misstatement of the financial statements conflicts with the law.
6. The 1985 Act also includes specific requirements relating to accounting records and the preparation of financial statements. Butterworths *Corporate Law Service* states that "*In the matter of financial control and prudence, the law is considerably more prescriptive and the statutory requirements to keep financial records of all transactions, and to prepare and file accounts according to precise rules and accepted formats, secure that a business is, in a book-keeping sense, well managed. Indeed the commonest reason for a director to be disqualified from office is a failure to keep proper accounting records.*"

### Directors

7. The duty of directors to keep accounting records is covered in Section 221 of the Companies Act 1985. The overriding requirement is in sub-section 221(1), which states that "Every company shall keep accounting records

which are sufficient to show and explain the company's transactions and are such as to:

- disclose with reasonable accuracy, at any time, the financial position of the company at that time; and
  - enable the directors to ensure that any balance sheet and profit and loss account prepared complies with the requirements of the Act.”
8. There are penalties for non-compliance. If a company fails to comply with the above provisions, every officer of the company in default is guilty of an offence unless (s)he shows that (s)he acted honestly and that under the circumstances the default was excusable. A person found guilty is liable to imprisonment, a fine or both.
9. In the Company Law Reform White Paper published in March 2005, the DTI announced proposals to codify in company law directors' duties that are currently in common law and equitable rules. Under draft clauses published with the White Paper, directors would be required to:
- act in a way which they consider would be most likely to promote the success of the company for the benefit of its members as a whole;
  - only exercise powers for the purpose for which they were conferred;
  - take account of the need for the company to maintain a reputation for high standards of business conduct; and
  - exercise reasonable care, skill and diligence.
10. The consequences of breach of any of the general duties would be the same as for breach of the corresponding common law rule or equitable principle.
11. New obligations have been placed on directors as a result of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005. These regulations require the directors of a quoted company to prepare an OFR for financial years beginning on or after 1 April 2005. The OFR will be included in the company's annual report and accounts, and compliance with the regulations will be enforced by the Financial Reporting Review Panel (FRRP) for financial years beginning on or after 1 April 2006.
12. The OFR must include, inter alia, information on the principal risks and uncertainties that may affect the company's long-term value. The Accounting Standard Board (ASB) published the reporting standard for the OFR<sup>8</sup> in May 2005. The reporting standard states that “*the OFR shall include a description of the principal risks and uncertainties facing the entity together with a commentary on the directors' approach to them*”.

---

<sup>8</sup> 'Reporting Standard 1: Operating and Financial Review', Accounting Standards Board, May 2005

## External auditors

13. The external auditors have duties under the Companies Act 1985 linked to the Section 221 requirements for directors. Section 237 states that “A company’s auditors shall, in preparing their report, carry out such investigation as will enable them to form an opinion as to whether:
  - proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them;
  - the company’s individual accounts are in agreement with the accounting records.”
14. If the auditors are of the opinion that:
  - either or both of the above requirements have not been complied with; and/or
  - they have failed to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their auditthen they shall state that fact in their audit report.
15. In relation to the OFR, auditors are required under the 2005 Regulations to state in their report whether in their opinion the information given in the OFR for the financial year for which the annual accounts are prepared is consistent with those accounts; and whether any matters have come to their attention, in the performance of their functions as auditors of the company, which in their opinion are inconsistent with the information given in the OFR.

## Listing Rules

16. As the UK’s competent authority under the Financial Services and Markets Act 2000, the UK Listing Authority (UKLA), part of the Financial Services Authority, is charged with making and enforcing the Listing Rules governing admission to listing. Updated Listing Rules will come into effect on 1 July 2005.
17. Paragraph 9.8.6 of the updated Listing Rules states that “in the case of a listed company incorporated in the United Kingdom, the following... items must be included in its annual report and accounts:
  - a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;
  - a statement as to whether the listed company has:
    - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
    - not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:
      - (i) those provisions, if any, it has not complied with;
      - (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
      - (iii) the company’s reasons for non-compliance”.

## The Combined Code

18. Disclosure is a major element of the Combined Code's requirements. The provision of meaningful and substantive information to investors is of fundamental importance. Code Principles concentrate on outcomes that boards need to achieve and Code Provisions are the 'comply or explain' part of the Code.
19. In respect of internal control, there is one Principle and one Provision in the Combined Code.
20. **Principle C.2** states that "The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets".
21. **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".
22. Under the Listing Rules, external auditors are required to review the directors' compliance statement relating to its review of the internal control system. The Auditing Practices Board (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.

## The Turnbull guidance

23. The Turnbull guidance (1999) provides guidance on how companies can apply the internal control principle and provision of the Combined Code and make the disclosures required of directors. The draft revised Turnbull guidance is set out in Appendix A1.

# Appendix C

## Draft 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. 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 April 2005 there are 1,275 such companies, operating across all business sectors.
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. This is set out in section 2 of the consultation paper, but in summary:
  - there is strong evidence 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.

## 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

9. 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 MORI 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.
10. **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 remain up to date.
11. **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 exercise 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.
12. 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.
13. 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 SEC<sup>9</sup>. Arguably it might also encourage companies to devote more resource to improving their financial reporting controls. However:
- As part of the 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 causes<sup>10</sup>. 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.

---

<sup>9</sup> As at December 2003 (the most recent available information) 111 UK incorporated companies were registered with the US Securities and Exchange Commission.

<sup>10</sup> 'Disarming the Value Killers: A Risk Management Study', Deloitte, 2005

14. 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

15. 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.
16. 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.

**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

17. 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.
18. 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"*.

19. 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 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.
20. 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.
21. 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.
22. There should be some benefits for investors as a result of more informative disclosures, 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 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.
23. 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.
24. **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.

25. 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.
26. 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.
27. There was very little support for **Option 3(a)** among respondents to the 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)<sup>11</sup>, 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 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;
  - 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.
28. 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 have a concern that making such a statement puts them at a disadvantage; on the other hand, doing so could be of benefit to the company if it provides 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.

---

<sup>11</sup> March 2005 survey by Finance Executives International, details are available at [http://www.fei.org/404\\_survey\\_3\\_21\\_05.cfm](http://www.fei.org/404_survey_3_21_05.cfm)

## The role of the external auditor

29. 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.
30. 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

31. 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.
32. **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.
33. **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.
34. 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)<sup>12</sup>. 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.

35. 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.
36. 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.
37. For many of the same reasons, respondents considered that any benefits associated with **Option 3** would be limited.
38. 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

39. 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.
40. 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.
41. 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,

---

<sup>12</sup> March 2005 survey by Finance Executives International, details are available at [http://www.fei.org/404\\_survey\\_3\\_21\\_05.cfm](http://www.fei.org/404_survey_3_21_05.cfm)

smaller companies are more likely than others to feel that the costs have outweighed the benefits, then any changes that reduced that flexibility may have a disproportionate impact on smaller listed companies. This is an additional argument against increased prescription.

## Enforcement and sanctions

42. 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”.
43. 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

44. 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.
45. 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.
46. A second consultation on the Review Group's recommendations will be carried out between June and September 2005. The intention is to publish updated guidance as soon as possible thereafter, to take effect in financial years beginning on or after 1 January 2006.

### Consultation with regulators

47. A Government observer from the DTI attended meetings of the Review Group. The Review Group has 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

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

### Summary and recommendations

49. 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 significantly 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.**
50. 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 requesting boards to confirm that necessary action has been or is being taken to remedy any significant failings or weaknesses identified from the annual review.**

51. 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.**

## Contact point

Chris Hodge  
Corporate Governance Unit  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

E-mail: [c.hodge@frc.org.uk](mailto:c.hodge@frc.org.uk)  
Telephone: 020 7492 2381

# Appendix D

## Members of the Review Group

Douglas Flint	Group Finance Director, HSBC Holdings plc (Chairman)
Stuart Bridges	Group Finance Director, Hiscox plc
John Coombe	Former Chief Financial Officer, GlaxoSmithKline plc
Michael Hughes	UK Chairman of Audit, KPMG LLP
Rosemary Martin	General Counsel and Company Secretary, Reuters Group PLC
Michael McLintock	Chief Executive, The M&G Group
John Mew	Executive Partner, Grant Thornton UK LLP
Graham Pimlott	Non-Executive Director of Provident Financial plc and Deputy Chairman of Hammerson plc
Alec Richmond	Head of Group Audit, Cadbury Schweppes plc
Paul Walsh	Chief Executive Officer, Diageo plc
Tony Watson	Chief Executive, Hermes Pension Management Limited
Robert Hodgkinson	ICAEW (Secretary)
Jonathan Hunt	ICAEW (Assistant Secretary)

### Observers

Chris Hodge	Financial Reporting Council
Stephen Spivey	Department of Trade and Industry

## Terms of Reference

To review and update where necessary the Turnbull guidance, in the 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.