SARBANES-OXLEY INTERNAL CONTROL PROVISIONS:
FILE NUMBER 4-511

Submission from the Financial Reporting Council

Introduction

1. The Financial Reporting Council (FRC) is the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom. As part of its remit, the FRC has responsibility for the document entitled *Internal Control - Guidance to Directors on the Combined Code*, also referred to as the Turnbull guidance. The guidance is recognised by the SEC as one of the frameworks that are available to issuers for the purposes of compliance with SEC Rule 33-8238 relating to Section 404(a) of the Sarbanes Oxley Act.

2. The guidance is 15 pages in length and sets out high-level principles with the aim that any company (large or small) 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. The guidance is not restricted to internal control over financial reporting, but intended to be applied to all internal controls.

3. In 2004 the FRC established a Review Group chaired by Douglas Flint (Group Finance Director of HSBC Holdings plc) to review and update the Turnbull guidance in the light of experience in implementing the guidance and developments in the UK and internationally since its introduction in 1999. Robert Hodgkinson, Secretary to the Turnbull Review Group, participated as a panel member in the SEC Round Table on the Sarbanes-Oxley internal control provisions held in April 2005, and the Group made a submission explaining the purpose of the review. At that point the Review Group was analysing the evidence it had gathered during an initial consultation phase and had not yet published its recommendations on whether the Turnbull guidance should be amended. The purpose of this submission is to report on the outcome of the review.

Main findings of the Turnbull Review Group

4. The evidence gathered by the Review Group represented the views and experience of a significant proportion of the London market. Responses to the initial consultation paper were received from listed companies which, as of February 2005, represented 56% of the total market capitalisation of UK companies listed on the London Stock Exchange's Main Market, from institutional investors that were between them responsible for funds under management in excess of $4,200 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.

5. There was a strong degree of consistency of opinion on the main issues, with the overwhelming view being that since its publication in 1999 the Turnbull guidance has contributed to better understanding and management of risk and improvements in internal control in UK listed companies.

6. 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. As a result, the Review Group proposed only limited changes to those parts of the guidance dealing with maintaining and reviewing the internal control system.

7. The Review Group considered whether the disclosure requirements of Section 404 constitute an appropriate model for disclosures made in the UK under the Combined Code and Turnbull guidance, and concluded that they did not. In part this was because of the broader scope of the Combined Code and Turnbull guidance, which cover all internal controls and not just those relating to financial reporting. The Review Group did not consider that the concept of 'effectiveness' was appropriate 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.

8. In the Review Group's opinion a requirement for a statement that processes are effective would be likely to lead to expensive testing and verification work to a low level of detail. The Review Group was also 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. In addition, the Review Group noted that there was little encouragement from investors for Section 404 style disclosures, and concluded that the potential benefit of such a statement to shareholders was not sufficient to outweigh the associated costs. However, the Review Group considered that companies should be encouraged to make the internal control statement more informative for shareholders.

9. The Review Group also considered the role of the external auditor. In the UK external auditors of listed companies are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system, and to add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge. 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. There is no requirement on the auditor to express a view publicly on the effectiveness of the company's internal control system.

10. There was virtually no demand from investors or companies for an increased role for external auditors. The existing powers and remit of the external auditors were considered sufficient; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls. The Review Group therefore recommended that there should be no expansion of the external auditors' responsibilities in relation to the company's internal control statement.

Changes to the Turnbull guidance

11. The Review Group published its conclusions and began consultation on proposed changes to the Turnbull guidance in June 2005. These changes enjoyed broad support, with the result that revised guidance was issued in October 2005, to apply to financial years beginning on or after 1 January 2006. A copy of the revised Turnbull guidance is enclosed for information.

12. As noted above, only limited changes have been made to the Turnbull guidance. The most significant of these relate to disclosure. Under the revised guidance, boards will be required to confirm in the annual report 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, and to include in the annual report such information as they consider necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control.

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28 April 2006

Financial Reporting Council

Internal Control

Revised Guidance for Directors on the Combined Code

October 2005

FINANCIAL REPORTING COUNCIL

INTERNAL CONTROL

REVISED GUIDANCE FOR DIRECTORS ON THE COMBINED CODE

OCTOBER 2005

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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 importance of regular and systematic assessment of the risks facing the business and 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 review whether they can make more of 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 help shareholders understand the risk and control issues facing the company, and to explain 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
October 2005

One - 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.

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.

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.

Two - 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 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.

Three - 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 based on the information and assurances provided to it, exercising the standard of care generally applicable to directors in the exercise of their duties. 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. The board 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.

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.

Four - 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.

Five - 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 it 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.

- 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 or weaknesses 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.

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