Response on behalf of The Association of Corporate Treasurers to

The Review of the Turnbull Guidance on Internal Control

The Turnbull Review Group, December 2004

Introduction

The Association of Corporate Treasurers (ACT)

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.
The ACT usually comments from the corporate and not the financial services sector standpoint.

Contact details are provided on the last page of these comments.

This Consultation

The ACT welcomes the opportunity to submit views on this topic to the Review Group.

We note that the primary purpose of the FRC's current consultation is to gain a good understanding of how the Turnbull guidance has been implemented in practice and where improvements can be made.

One aim of the original guidance was to make Boards of Directors more aware of the risks facing their businesses so that they could not only be identified, but more importantly be managed with the appropriate controls. There was an objective that the concepts of risks and internal controls would become inbuilt into the normal management processes.

To an extent therefore the evidence gathering phase of the Turnbull Review Group will be dependent on specific and possibly confidential inputs directly from companies that have applied the guidance. As a professional association we can comment from an external perspective and based on inputs received from our members, but with the caveat that in some respects we may be at one stage removed from the direct process.

In compiling this response input has been received from individuals with company specific experience and from the ACT's Technical Committee comprised of members operating in non financial corporates, financial institutions and in advisory services.

Questions and responses (Some questions are grouped with a single response)

1. *Has the Turnbull guidance succeeded in its objectives?*

2. Are companies behaving differently as a result of the guidance? In particular, has the guidance had an impact on:

- *the understanding of risks and controls (a) at board level; and (b) more widely within companies and groups?*
- *the way boards have approached business risk and strategy?*
- *the risk appetite of the board?*
- *improving the quality of risk management and internal control*
- *within companies?*
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3. What difficulties, if any, have organisations had in implementing the Turnbull guidance?

It would appear that the Turnbull Guidance has been highly effective in raising the awareness of risks and controls both at board level and within companies and groups and indeed indirectly amongst a very much wider public including public sector bodies, charities, clubs and all manner of organisations.

The Listing Rules (para 12.43A) requiring a statement as to how the company has complied with the Combined Code requirements on internal control systems has provided an effective self enforcement mechanism.

In the early days the spirit of Turnbull was sometimes too narrowly interpreted in that the approach to risk management in organisations was often bottom up and centred around the creation of risk registers. Often this was an annual exercise undertaken by a "risk manager". The concepts of risks and controls were not really built into the day to day management process. While this may have been an acceptable way of starting to the process, and useful at operating unit levels, Turnbull had implied that for any organisation there were unlikely to be more than a dozen really important risks and to which the Board's attention should be directed.

Practice has evolved and we believe that boards are now taking a far better risk based approach to internal controls and to management decision making generally. No doubt there is room for further improvement.

4. *Should the guidance continue to retain a high level and risk-based approach to internal control rather than move to a more prescriptive approach?*

The original guidance was short and readily understandable. This apparently informal approach and style has with hindsight been very successful in making the guidance applicable to a variety of circumstances. Companies have been able to develop an internal control system appropriate to themselves, and which then stands a better chance of being applied well and continuously adapted to changing circumstances, internal and external.

An overly prescriptive set of rules has the danger of being applied in circumstances where it does not fit well, is seen as irrelevant, and discredited and a mere "box ticking" exercise.

5. Should the guidance continue to cover all controls?

Financial controls are inevitably important and indeed essential to the integrity of a company's financial reporting, but are by no means paramount when it comes to managing the overall business. Many risks may end up being measured in terms of financial impact but the crucial risk will very often not be directly caused by financial matters. For example, product or service quality and the many factors affecting brand image and reputational risk generally can, if not well managed, have as great a destructive effect as financial fraud or poor financial risk management.

Although the "rules" in Turnbull are far less extensive than those arising from Sarbanes-Oxley in the USA the scope of Turnbull is far more extensive, since Sarbanes Oxley is concentrated on financial controls. Turnbull is likely over time to be more effective at lower cost.

6. Are there parts of the guidance on internal control that are (a) out of date or now unnecessary; (b) unclear; or (c) lacking in sufficient detail? If so, please identify them.

7. *If additions are needed to the guidance, what form should they take, what should they cover, and why would they be useful? Examples might include:*

- *additional questions in the current appendix;*
- *indicators to help boards and board committees identify where there may be potential cause for concern, for example of fraud or aggressive earnings management; or*
- *more examples of the types of risks that boards should consider, for example business continuity risk.*

8. Do you have any other suggestions for changes to the guidance that are not covered by questions 6 and 7 above?

The Appendix to the Turnbull Guidance includes a non exhaustive list of some of the questions a company might want to assess. Although not essential it might be helpful in getting individuals thinking along the right lines to include a list of some generic risk types along with a brief description of what is meant and examples of how the risk can arise. One word headings are given at present covering market, credit, liquidity, technological and other risks. Additions could include product, cost base, personnel, fraud, terrorism and other emergencies risks.

9. *How useful to investors and companies are the existing disclosures on internal control? What value is placed on such disclosures by investors when making investment decisions?*

Existing disclosures of the nature of controls may be summarised as saying that appropriate controls are in place. Requirement for greater disclosure would risk replication of chunks of internal control/risk management manuals making the disclosure too tedious to have real effect.

10. Would a different or extended form of disclosure facilitate better decision making? If so, how?

11. What distinctions or linkages should be made between the business risk-related disclosures to be made in the Operating and Financial Review and the disclosures made as a result of the Turnbull guidance?

The place for extended consideration is the OFR which is a longer, self-standing document. Here, the risks and any particular features of the related controls/risk management processes can be considered in a more useful relationship. Not all risks to be considered in the OFR are subject to internal control but to may require internal response systems. It is important to avoid excessive detail. We hope that the OFR standards when finalised will encourage this.

12. What are the advantages and disadvantages of turning the board's private assessment of effectiveness into a public statement of their conclusion on effectiveness?

13. Would boards and investors wish to see additional disclosures on the outcomes of the boards' review of effectiveness and actions taken following that review? If so, what information would be appropriate?

We see no advantage in requiring significant detail here. It should be sufficient to say that any identified (relative) weaknesses have been tackled. A robust attitude to materiality is needed to avoid obscuring important matters with trivia.

14. What benefit does the existing work performed by external auditors on internal control, and the subsequent dialogue with the board, provide to:
(a) the board of a company; and
(b) investors?

Unless especial studies of internal controls are requested (on a consultancy basis), 'Audit' of internal controls is very limited. The extent of the auditors' own testing as part of the normal audit will, of course, be influenced by their assessment of the effectiveness of controls. It is important to avoid excessive requirements, falling into the SOX trap.

15. What are the advantages and disadvantages of extending the external auditors' remit beyond the existing requirements? If you consider that any change should be made to the existing remit, what might this be and why?

The current approach requires exercise of judgement in each case - a good balance of rigor and flexibility and seems to be very effective. It is in the interests of the UK as a financial centre to avoid going the US way with excessive prescription. Of course risks are not totally eliminated. We would not normally regard their spectacular realisation in a scandal as of itself cause to move to the more prescriptive route which itself cannot eliminate all risk.

In many cases of control failure problems have been in very fundamental matters. Limited testing of controls in these areas by auditors may accordingly be of low cost and may help avoid some problems. As important would be external auditors' talking informally, one to one, to staff at various levels in the organisation about how comfortable they are with matters in their own purview. Because of the cost pressures on and within audit firms and the time-pressured nature of much of their work in a company, such discussion almost never happens except at the head of function/finance director level.

16. What impact, if any, might an extended role for the external auditor have on the relationship and dialogue between the external auditor and the board and its committees?

Under the existing role the auditor should be familiar with the controls set up, even if they have not actually tested it. An added audit certification would not change much as regards the board relationship. If audit programmes included time for the type of informal discussion which we refer to in the answer to the last question, only in companies where there was a problem with the internal control culture would there be material change in the relationship at board level.

17. Are there any other matters that should be brought to the attention of the Review Group?

While there is always scope for improvement, we do not see evidence that the current arrangements are not actually working. It is important to avoid change for its own sake, especially given the huge agendas companies have on corporate governance and accounting standards changes at present.

Given what we believe to be the relative success of the current Turnbull guidance arrangements, it is important that they are updated as need be to capture relevant changes called for at EU level rather than their being interpreted in a more prescriptive and rule-bound manner if at all possible.

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