

13 September 2005

The Turnbull Review Group
Financial Reporting Council
Fifth Floor
Aldwych House
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LONDON
WC2B 4HN

Dear Sirs

**FRC CONSULTATION ON
THE TURNBULL GUIDANCE ON INTERNAL CONTROL**

The IMA is the trade body representing the UK asset management industry. IMA Members include independent fund managers, the asset management arms of retail banks, life insurers, investment banks and occupational pension scheme managers. They are responsible for the management of approximately £2 trillion of funds (based in the UK, Europe and elsewhere), including institutional funds (for example, pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members manage 99% of UK-authorized investment funds (collective investment schemes).

In managing assets for both retail and institutional investors, IMA Members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Turnbull Guidance on Internal Control from the standpoint of institutional investors.

We welcome the review of the Guidance. The Guidance was last amended in 1999 and it is appropriate that it should now be reviewed to determine if it needs to be updated. We also welcome the process that the Review Group is following in that it initially gathered evidence to inform the current consultation.

We appreciate that the Review Group is proposing to continue to set high level principles and is not seeking to be more prescriptive – this means that boards will have to think seriously about their company's risks and internal controls in applying the Guidance. 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.

That said, the current disclosures on the system of internal controls in many annual reports are of limited use in that they have become standardised such that there is

very little to differentiate between different companies. Whilst we appreciate the review Group's attempts to improve this, we fear that the proposal for boards to confirm in annual reports that necessary action has been or is being taken to remedy any significant failings or weaknesses will also become standardised.

Our Members will enter into constructive dialogue with companies and make their own assessment and we do not necessarily want to impose more burdensome reporting requirements on companies. However, engagement would be facilitated, and the amount of time and resources required of investors and companies could well be reduced, if there was more transparency and meaningful information in annual accounts. In particular, whilst there may be difficulties in requiring boards to conclude on the effectiveness of internal controls, we would welcome more transparency on how risks are monitored and controlled, and how the effectiveness of the controls is assured. As noted, we support a principles based approach and would not favour this being prescribed and hope that UK companies will respond accordingly.

We welcome the Guidance being updated to reflect:

- changes to the Combined Code and the Listing Rules;
- the proposed directors' duties in the Company Law Reform Bill; and
- the new Operating and Financial Review (OFR).

This will help ensure consistency and eliminate the confusion that could otherwise arise. That said, there are certain anomalies in that the scope of the requirements relating to the OFR and the Company Law Reform Bill are different from that of the Combined Code and the Turnbull Guidance - the requirements relating to the former are in the Companies Act, and apply to UK incorporated quoted companies, and the Turnbull Guidance and Combined Code are listing requirements that apply to companies with a listing in the UK, wherever incorporated. This also means that there are different sanctions if companies fail to fulfil their obligations under the respective requirements. We believe that these requirements should be better aligned and that the main risk-management processes disclosed as part of the Turnbull guidance should address the risks disclosed in the OFR. The Guidance should make this explicit in the interests of ensuring comprehensive and consistent disclosures.

We set out in the attached annex some detailed comments on the proposed changes to the Guidance. Please call me on 020 7269 4668 if you would like to discuss any of the points in this letter or the attached, or if you would like to discuss any issues further.

Yours faithfully

Liz Murrall
Senior Adviser – Corporate Governance

IMA RESPONSE TO FRC CONSULTATION ON THE TURNBULL GUIDANCE ON INTERNAL CONTROL

The IMA's detailed observations on the proposals in the CP are set out below.

A, B & C. The Review Group is not proposing to make significant changes to the guidance and it is to continue to cover all internal controls.

The IMA agrees that significant changes to the Guidance are not required in that it appears to have achieved its objectives in ensuring that companies maintain an adequate system of internal control and that the system is subject to regular review. We also support the Guidance covering all controls, including financial, operational and compliance controls, and risk management systems. A company is subject to a variety of risks and must have an effective system that monitors and controls all of them to safeguard shareholders' investments and its own assets.

D. A new preface is to be added which will encourage companies to review on a continuing basis their application of the guidance and look on the internal control statement as an opportunity to communicate with shareholders on how they manage risk effectively.

We welcome the new preface and hope that it will prompt companies to undertake a thorough examination of the effectiveness of their own systems of internal control on a regular basis to see if they need to be modified and updated. That said, although we believe the existing Guidance appears to have achieved its objectives in ensuring that companies maintain an adequate system of internal control and that the system is subject to regular review, our Members are not necessarily being given sufficient details on this - see below and our observations on Ev.

E. The Guidance is to be amended to:

- i. reinforce the message that it is intended to reflect sound business practice by re-ordering the introduction;
- ii. reflect changes in the Combined Code and the Listing Rules;
- 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 on directors' duties in the draft Company Law Reform Bill;
- iv. remove the section related to internal audit as this is now dealt with in the Combined Code;
- v. require that boards confirm that necessary action has been taken to remedy any weaknesses identified from their review and report such information to assist shareholders in understanding the company's risk management systems.

The IMA supports the introduction being reordered to emphasise the importance of risk management and thus reflect sound business practice (i) and amendments to reflect changes to the Combined Code and the Listing Rules (ii and iv) - the existing references refer to the Code issued in June 1998 and not to the more recent version of July 2003 or to the recently revised Listing Rules. In addition, we welcome the

Guidance reflecting the proposed statement on directors' duties in the Company Law Reform Bill (iii) as it would be confusing if there were different obligations.

As regards changing the disclosures (v), we noted in our response dated 7 March that the existing disclosures "on the system of internal controls in many annual reports are of limited use. This is mainly as the paragraphs concerned have become standardised such that there is very little to differentiate between different companies".

Thus investors cannot determine the risks a company faces and how these risks are monitored and controlled from the accounts on their own. In this respect, for financial years beginning on or after 1 April 2006, under Schedule 7ZA of the Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2004, quoted companies will be required to prepare an OFR that includes "a description of the principal risks and uncertainties facing the company and its subsidiary undertakings".

If this works as intended then investors will be informed of the key areas of risk. However, investors would also appreciate knowing how those risks are monitored and controlled, and how the controls are assured. Few companies disclose the information required by paragraph 36 (old paragraph 38) of the Guidance "the board should summarise the process it has applied in reviewing the effectiveness of the system of internal control. 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".

We fear the proposal that boards should confirm in annual reports that necessary action has been or is being taken to remedy any significant failings or weaknesses will become standardised as for the existing disclosures. Although, our Members will enter into constructive dialogue with companies and make their own assessment and we do not necessarily want to impose more burdensome reporting requirements on companies, engagement would be facilitated, and the amount of time and resources required of investors and companies could well be reduced, if there was more transparency and meaningful information in annual accounts and details were disclosed of how risks are monitored and controlled, and how the effectiveness of the controls is assured. As noted, we support a principles based approach and would not favour this being prescribed and hope that UK companies will respond accordingly.

F. It is not proposed that Boards will have to make a statement on the effectiveness of the company's internal control systems.

The problems of requiring the board to state publicly their conclusions on the effectiveness of the internal controls were recognised in the earlier consultation document in that there are difficulties in defining effective and directors could be concerned that such a statement could leave them open to increased litigation and liability. Whilst we acknowledge these concerns, we would question the value of the existing disclosure that "the board has reviewed the effectiveness of the system of internal controls" if requiring them to conclude on the effectiveness would discourage them from being frank about shortcomings and would involve additional costs. As noted in E above, we would welcome improved disclosure of how risks are monitored and controlled, and how the effectiveness of the controls is assured.

G. Companies that are already applying the Turnbull Guidance will not need to develop additional processes in order to comply with the requirement to identify the principal risks in the OFR and are encouraged to ensure that the OFR and internal control statement are complimentary.

As noted, for financial years beginning on or after 1 April 2006, quoted companies will be required to prepare an OFR that includes "a description of the principal risks and uncertainties facing the company and its subsidiary undertakings".

If this works as intended then the key risks should be identified in the annual report. Whilst we appreciate the Review Group stating that the OFR and internal control statement should be complementary, we believe that the main risk-management processes disclosed as part of the Turnbull Guidance should be aligned with the risks disclosed in the OFR. It would be helpful if the Guidance made this explicit in the interests of ensuring comprehensive and consistent disclosures. We do not believe that the statement that companies already applying the Turnbull guidance will not need to develop additional processes in order to comply with the requirement to identify the principal risks in the OFR, necessarily goes far enough.

In this respect, there are certain anomalies in that the scope of the requirements relating to the OFR and the Turnbull Guidance are different - the requirements relating to the OFR are in the Companies Act, and apply to UK incorporated, quoted companies, and the Turnbull Guidance is in the Combined Code which is a listing requirement and applies to companies with a listing in the UK, wherever incorporated. This also means that there are different sanctions if companies fail to fulfil their obligations under the respective requirements. It would be helpful if these were better aligned.

H. There should be no expansion of the external auditors' responsibilities in relation to the internal control statement.

The IMA agrees that generally the existing role of the auditor in relation to the disclosures is sufficient and does not need to be extended. If anything it should be changed to focus on the substance as opposed to the procedure and aligned with the requirement in respect of the OFR: to state whether the information given in the OFR is consistent with a company's accounts as well as whether any other matters that came to their attention in the performance of their functions as auditors of the company.

In addition, we suggest that the new guidance could enhance the role of internal audit in reviewing the effectiveness of internal controls on behalf of the board.

I. Revised guidance should take effect for financial years beginning on or after 1 January 2006.

The IMA believes that the changes proposed are minimal and that requiring the revised guidance to take effect for financial years beginning on or after 1 January 2006 should give companies more than sufficient time to implement it.