

7 March 2005

The Turnbull Review Group
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
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. The review is likely to prompt companies to undertake a thorough examination of the effectiveness of their own systems of internal control to see if they need to be modified and updated.

We also welcome the process that the Review Group is following in that it is initially, as part of this consultation, gathering evidence which will inform an analysis of the Guidance to see if any changes are necessary. If changes are proposed then it is intended that there is a second consultation on revised draft guidance in mid-2005. We particularly appreciate the fact that as part of this, the Review Group is intending to publish a Regulatory Impact Assessment which will explain the expected costs and benefits of any proposed changes to the Guidance.

As regards the existing Guidance, we believe 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. That said, our Members are not necessarily being given meaningful information.

One of the main sources of information on the implementation of the Guidance is the disclosures companies provide in their annual reports. Provision C.2.1 of the Combined Code requires 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".

In this respect, the 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' disclosures. Thus our Members are unable to assess the risks a company faces and how these risks are monitored and controlled from the accounts on their own. Our Members tend to enter into constructive dialogue with the companies in which they have an interest to enable them to make their own assessment. This 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 more meaningful information in annual accounts. That said, we would not seek to impose more burdensome reporting requirements on companies and are mindful of their existing obligations. However, it would be helpful if disclosures were less standardised and included more meaningful information.

We set out in the attached annex some detailed comments on the questions in the CP. 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 THE FRC CONSULTATION PAPER ON THE TURNBULL GUIDANCE

The IMA's detailed comments on the questions in the CP are set out below.

Objectives

Q 1 Has the Turnbull guidance succeeded in its objectives?

As regards the existing Guidance, we believe 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. That said, our Members are not necessarily being given sufficient details on this.

One of the main sources of information on the implementation of the Guidance is the disclosures companies provide in their annual reports. Provision C.2.1 of the Combined Code requires 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".

In this respect, the 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' disclosures. Thus our Members are unable to assess the risks a company faces and how these risks are monitored and controlled from the accounts on their own. Our Members tend to enter into constructive dialogue with the companies in which they have an interest to enable them to make their own assessment. This 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 more meaningful information in annual accounts. That said, we would not seek to impose more burdensome reporting requirements on companies and we are mindful of their existing obligations. However, it would be helpful if disclosures were less standardised and included more meaningful information.

On a minor point, the existing references in the Guidance to the Combined Code refer to the Code issued in June 1998 and not to the more recent version that was issued in July 2003. These references should be updated.

Q 2 Are companies behaving differently as a result of the guidance? In particular, has the guidance has 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 a strategy?*
- *the risk appetite of the board?*
- *improving the quality of risk management and internal control within companies?*

Q 3 What difficulties if any have companies had in implementing the Turnbull guidance?

Questions 2 and 3 are outside the IMA's remit.

The scope of the guidance

Q 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 IMA supports the Guidance adopting a high-level and risk-based approach rather than one that is detailed and prescriptive. As intended, this 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.

Q 5 Should the guidance continue to cover all controls?

The IMA supports 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. We do not believe that guidance that only covered controls over financial reporting, as required by Sarbanes Oxley, would provide sufficient assurance. In particular, in the financial sector the distinction between financial and other internal controls is arbitrary and impractical.

The detail of the guidance

Q 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.

Q 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 risk that boards should consider, for example, business continuity risk.*

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

Questions 6 to 8 are outside the IMA's remit.

Reporting: current disclosure requirements

Q 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?

As noted above, the existing disclosures in many annual reports are of limited use in that they tend to be standardised and boilerplate. For example, few companies disclose the information set out in paragraph 36 of the Guidance "additional information in the annual report and accounts to assist understanding of the company's risk management processes and system of internal control". Similarly,

paragraph 38 “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”.

Thus investors are unable to determine the risks a company faces and how these risks are monitored and controlled from the accounts on their own. Investors are increasingly interested in the effectiveness of a company’s internal controls and would value more informative disclosures. Although more detailed and descriptive disclosures would assist investors they are not vital to a decision as to whether to buy a particular company’ shares or to retain an existing holding. Our members tend to rely on their on discussions with a company’s management, customers and suppliers as well as an analysis of results.

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

As noted in question 9, from the existing disclosures, investors are unable to determine the risks a company faces and how these risks are monitored and controlled. It would be helpful if companies highlighted what they see as the key risks to their business and detailed how these risks are monitored and controlled. In this respect, the Companies Act 1985 (Operating and Financial Review and Directors’ Report) Regulations 2004 will require quoted companies to prepare an Operating and Financial Review (OFR) and in accordance with Schedule 7ZA, this must always include “a description of the principal risks and uncertainties facing the company and its subsidiary undertakings”.

As regards the Turnbull Guidance, provision C.2.1 of the Combined Code states that “the review should cover all material controls, including financial, operational and compliance controls and risk management systems”. We believe the main risk-management processes disclosed as part of the Turnbull guidance should be aligned with the risks disclosed in the OFR. It would help if the Guidance made this explicit in the interests of ensuring comprehensive and consistent disclosures.

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.

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

Please see our response to question 10 above.

Reporting: effectiveness statements

Q 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?

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

As stated in the CP, the difficulties of requiring the board to state publicly their conclusions on the effectiveness of the internal controls are that: effective can be difficult to define; and directors could be concerned that such a statement would leave them open to increased litigation and liability. We would question the value of the existing disclosure that "the board has reviewed the effectiveness of the system of internal controls" if, as stated in the CP, requiring them to conclude on the effectiveness would discourage them from being frank about shortcomings and would involve additional costs.

As stated elsewhere in this response, we would value more informative disclosures that indicated areas of risk, how those risks are monitored and controlled and that those controls that are effective and those which need to be developed. We consider that concerns about litigation and liabilities could be alleviated, in the same way an auditor explains to management in the audit management letter, that the letter only includes those matters which have come to his attention as a result of the audit procedures (review in this case) and that it should not be relied on as a comprehensive statement of all weaknesses that exist or of all improvements that might be made.

The role of external auditors

Q 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?

Q 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?

Q 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?

The IMA considers that the existing role of the auditor in relation to the disclosures is sufficient and does not need to be extended. To ensure it focuses on the substance as opposed to the procedure, we believe it should be aligned with the audit 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.