The Institute of Chartered Accountants in England & Wales

Internal Control

Guidance for Directors on the Combined Code

ISBN 1 84152 010 1

Published by

The Institute of Chartered Accountants
in England & Wales
Chartered Accountants' Hall
PO Box 433
Moorgate Place
London EC2P 2BJ
Internet: www.icaew.co.uk/internalcontrol

Further copies can be obtained from:

Accountancy Books
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London WC1N 1QP

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www.accountancybooks.co.uk

September 1999

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Foreword

from the London Stock Exchange

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 & 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, is 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 clarifies to boards of directors of listed companies what is expected of them.
We consider that compliance with the guidance will 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in full by a company the guidance on Internal Control and Financial Reporting (the Rutteman guidance) will have been superseded and full compliance with the Combined Code and Listing Rule requirements is possible.

Paul Geradine
Head of Listing
London Stock Exchange

September 1999

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Introduction

Internal control requirements of the Combined Code

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.

2. Principle D.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’.

3. Provision D.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 controls, including financial, operational and compliance controls and risk management’.

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’.

5. Paragraph 12.43A of the London Stock Exchange Listing Rules states that ‘in the case of a company incorporated in the United Kingdom, the following additional items must be included in its annual report and accounts:

   (a) a narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied;

   (b) 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’.

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.

7. The guidance in this document should be followed by boards of listed companies in:

- assessing how the company has applied Code principle D.2;
- implementing the requirements of Code provisions D.2.1 and D.2.2; and
- reporting on these matters to shareholders in the annual report and accounts.

Objectives of the guidance

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 Code relating to internal control and reporting to shareholders thereon.

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.

The importance of internal control and risk management

10. 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.

11. Internal control (as referred to in paragraph 20) facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.

12. 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.

13. 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.

Groups of companies

14. 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

15. 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

16. 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 risks in the manner which it has approved.

17. 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.

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.

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

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.

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.

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.

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.

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

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 after due and 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.

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. The board takes responsibility for the disclosures on internal control in the annual report and accounts.

The process for reviewing effectiveness

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.

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 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.

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.

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, could 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.

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.

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.

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;
- 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.

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 re-assess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

The board's statement on internal control

35. In its narrative statement of how the company has applied Code principle D.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.

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

37. The disclosures relating to the application of principle D.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.

38. In relation to Code provision D.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. 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.

39. Where a board cannot make one or more of the disclosures in paragraphs 35 and 38, 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.

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

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

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 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.

1. 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? (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?

2. 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.

- 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?

3. 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 laws or regulations or other improprieties?

4. 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?

Membership of the Internal Control Working Party

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