



## Financial Reporting Council

Aldwych House, 71-91 Aldwych, London WC2B 4HN  
Telephone 020 7492 2300 Fax 020 7492 2301

[www.frc.org.uk](http://www.frc.org.uk)

Chairman: Sir Bryan Nicholson

Chief Executive: Paul Boyle

Secretary: Michael Lewington

Mr Jonathan G Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington DC 20549-0609  
USA

31 March 2005

Dear Sir

### **Sarbanes-Oxley Internal Control Provisions - File number 4-497**

#### Introduction

The Financial Reporting Council (FRC) is the independent regulator responsible for promoting confidence in corporate reporting and governance in the United Kingdom. The activities of the FRC are overseen by a Council which includes representatives from companies, investors and the accountancy profession.

As part of its remit, the FRC has responsibility for the Combined Code on Corporate Governance and related guidance, an important element of which is 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.

As a regulator, the FRC is unable to provide the Commission with direct experience of implementing and evaluating the requirements of Section 404 of the Sarbanes Oxley Act 2002. We are, however, pleased to inform the Commission of the work that the FRC is undertaking in its review of the Turnbull guidance, originally published in 1999.

#### The Turnbull Review Group

The FRC has established a Review Group, chaired by myself, Douglas Flint (Group Finance Director of HSBC Holdings plc), comprising senior, experienced individuals from investment institutions, listed companies and auditors, together with an observer from the UK government. The full list of the individuals on the Review Group, its terms of reference and its approach to the review is included in Appendix B of the attached consultation document.

## UK framework

The Turnbull guidance is one part of a broader regulatory framework governing internal control that applies to companies listed on the London Stock Exchange. It is necessary to understand the framework within which the Turnbull guidance operates to appreciate the context of our current review. This is summarised in Appendix A.

The UK Combined Code adopts a 'comply or explain' approach to provide a robust but flexible approach for listed companies of all size. The Combined Code also contrasts with Section 404 by taking a wide business and investor perspective of controls rather than the more limited approach of internal control over financial reporting. We believe that the UK framework is successful and pragmatic.

## Progress on the review

The Turnbull Review Group is engaged in its evidence-gathering phase and is currently analysing responses to its consultation paper which closed on 2 March 2005. A copy of the consultation paper is attached for your information and may also be downloaded from [www.frc.org.uk/corporate](http://www.frc.org.uk/corporate).

We have received responses from major investment institutions and their representative bodies, from companies listed in the UK (some of whom are also SEC registrants) as well as from external and internal auditors, risk managers and other interested parties. We are also gathering evidence through telephone surveys and round table-type events.

The Review Group expects to publish proposals for revisions, if any, to the Turnbull guidance in mid-2005 and these will be the subject of a further consultation process.

We will be happy to share with the Commission our summary of evidence gathered and our proposals when they are available.

Yours sincerely

**Douglas Flint**  
Chairman  
Turnbull Review

## The UK framework

The Turnbull guidance is part of a framework that comprises:

- company and common law;
- the Listing Rules;
- the Combined Code on Corporate Governance; and
- the Turnbull guidance.

### Company and common law

Directors have duties under common law and in legislation.

Under common law, directors have fiduciary duties to the company that include duties relating to their stewardship of the company's assets that are under their control and must be applied for the company's specific purpose. Duties to the company include the duty of skill and care of the directors which, when operating and making decisions as a board, requires them to:

- act in good faith in the best interests of the company;
- use powers conferred on them for the proper purpose; and
- exercise skill and reasonable care when acting in the company's interest.

In addition legislation, such as the Companies Act 1985, imposes specific duties on the directors of a company. Under the Companies Act, for example, directors are required to prepare financial statements that give a 'true and fair' view and for those financial statements to be independently audited. Considerable care is thus required in the preparation of financial statements and deliberate misstatement of the financial statements conflicts with the law. The Act also includes specific requirements relating to accounting records and the preparation of financial statements.

### Directors

The duty of directors to keep accounting records is covered in Section 221 of the Companies Act 1985. Although sub-sections 221(2) and 221(3) go into more detail on the contents of accounting records, the overriding requirement is in sub-section 221(1), which states that "Every company shall keep accounting records which are sufficient to show and explain the company's transactions and are such as to:

- disclose with reasonable accuracy, at any time, the financial position of the company at that time; and
- enable the directors to ensure that any balance sheet and profit and loss account prepared complies with the requirements of the Act."

There are penalties for non-compliance. If a company fails to comply with the above provisions, every officer of the company in default is guilty of an offence unless (s)he shows that (s)he acted honestly and that under the circumstances the default was excusable. A person found guilty is liable to imprisonment, a fine or both.

## External auditors

The external auditors have duties linked to the Section 221 requirements for directors. Section 237 states that “A company’s auditors shall, in preparing their report, carry out such investigation as will enable them to form an opinion as to whether:

- (a) proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them;
- (b) the company’s individual accounts are in agreement with the accounting records.”

If the auditors are of the opinion that:

- either or both of the above requirements have not been complied with; and/or
  - they have failed to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit
- then they shall state that fact in their audit report.

## **Listing Rules**

As the UK’s competent authority under the Financial Services and Markets Act 2000, the UK Listing Authority (UKLA), part of the Financial Services Authority, is charged with making and enforcing the Listing Rules governing admission to listing.

Rule 1.1 of the Listing Rules states that issuers must comply with all listing rules applicable to them. The Combined Code on Corporate Governance is appended to the Listing Rules.

Rule 12.43A of the Listing Rules states that in the case of a company incorporated in the United Kingdom, the following 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 investors to evaluate how the principles have been applied; and
- (b) a statement as to whether or not the company 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.

## **The Combined Code**

Disclosure is a major element of the Combined Code’s requirements. The provision of meaningful and substantive information to investors is of fundamental importance. Code Principles concentrate on outcomes that boards need to achieve and Code Provisions are the ‘comply or explain’ part of the Code.

In respect of internal control in the Combined Code, there is one Principle and one Provision.

Principle C.2 states that “The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets”.

Provision C.2.1 states 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. The review should cover all material controls, including financial, operational and compliance controls and risk management systems”.

## **The Turnbull guidance**

The Turnbull guidance (1999) provides guidance on how to apply the 1998 Code Principle D.2 (now Principle C.2 in the 2003 Code), comply with the related provisions and make the disclosures required of directors.

Paragraph 7 of the guidance states that it should be followed by boards of listed companies in:

- assessing how the company has applied the Code Principle on internal control;
- implementing the requirements of Code Provisions on internal control; and
- reporting on these matters to shareholders in the annual report and accounts.