

28 April 2006



ICAEW response: 27/06

Ms Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington DC 20549-1090  
USA

By e-mail: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Dear Ms Morris

### **File Number 4-511**

#### **Second-year experiences with implementation of Sarbanes-Oxley internal control reporting and auditing provisions**

The Institute of Chartered Accountants in England & Wales (the Institute) operates under a Royal Charter and, working in the public interest, is the largest professional accountancy body in Europe with over 127,000 members in business, public practice, investment institutions, the public and voluntary sectors and academe.

We are pleased to submit comments to the SEC-PCAOB roundtable and we commend you for holding the event and for collecting and publishing comments from interested parties.

The Institute is an experienced contributor to international work on corporate governance and internal control. We attach, as Appendix A, our letter of 1 April 2005 submitted ahead of last year's roundtable in which we set out:

- our credentials for commenting on this topic based on the direct experience of our members and our track record of thought leadership in risk management and internal control;
- our observations on implementing section 404 including our support for its overall objective but also our concerns about costs and unintended consequences, and the contrasting approach taken in the UK through the Turnbull guidance; and
- areas for future consideration including the need to establish a sense of proportion on the basis that financial reporting, whilst it is important, is but one aspect of corporate governance.

In this response we build on the comments in our previous letter by outlining key developments that have taken place over the past year, in particular:

- completion of the comprehensive review of the UK Turnbull guidance on internal control;
- follow-up to the FEE discussion paper *Risk Management and Internal Control in the EU*; and
- the Institute's work including thought leadership research into US and UK corporate governance and the experience of UK Foreign Private Issuers in implementing sections 302 and 404.

## **Principal comments**

We continue to believe that a fundamental question facing regulators, politicians, investors and business in the United States is what needs to be done to establish a sense of proportion. Well run and well controlled companies do not concentrate on internal control over financial reporting to the detriment of their management of other types of risk.

We are supportive of further measures to mitigate the effects of section 404 especially for smaller companies whether through exemptions from audit or increased emphasis on issues of high-level significance. However, we also suggest that careful consideration be given to the adequacy of such palliatives. In our view, a more fundamental review of the reporting and auditing requirements of section 404 is needed, learning from experience in competing capital markets outside the United States.

## **The 2004/5 review of the Turnbull guidance**

The Turnbull guidance on internal control published in 1999 was subject to a comprehensive review by the Turnbull Review Group (TRG) of the UK Financial Reporting Council (FRC). The review, announced in April 2004, was completed in October 2005 with the publication of revised guidance. A brief outline of the Turnbull guidance is attached in Appendix B and the auditors' related responsibilities are summarised in Appendix C.

We understand that the FRC is making a submission to you and note that:

- the review process involved two public consultation exercises, supported by supplementary evidence gathering aimed primarily at smaller listed companies;
- the evidence gathered represented the views and experience of a significant proportion of investors in, and companies on, the London main market; and
- there was strong consistency of opinion on the main issues, with the overwhelming view of respondents being that the Turnbull guidance had been a success and that companies of all sizes had been able to implement it intelligently and appropriately.

Based on the evidence gathered from investors, companies, auditors and other commentators, the TRG:

- rejected a section 404 equivalent for the UK, noting that the disclosure requirements of section 404 did not constitute an appropriate model for disclosures made in the UK under the Combined Code on Corporate Governance;
- recommended that there should be no expansion of the external auditors' existing responsibilities in relation to company statements on internal control; and
- made only a few changes to the 1999 guidance, principally to require boards to confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from their review of the effectiveness of the system of internal control.

When considering the relative merits of section 404 and the Turnbull guidance, it is important to appreciate that there are significant differences in scope and approach. Section 404 and the Turnbull guidance should be seen in the context of the broader regulatory frameworks of which they are essential parts. Section 404 is concerned solely with internal controls over financial reporting, while the Turnbull guidance covers all controls related to business risk management.

In its first consultation document, the TRG invited views on whether requirements similar to section 404 should be introduced in the UK. Almost all companies and most investors opposed the introduction of such requirements. The primary reason was that the perceived costs would be disproportionate to the benefits. Other arguments against public effectiveness statements were that:

- the concept of effectiveness is not meaningful for public reporting purposes when considering non-financial reporting issues, where a company's response to risk is determined by its risk appetite and cannot be mandated by reference to an objective standard;
- a declaration that an internal control system was 'effective' could easily be taken to mean that nothing could go wrong, thereby creating an expectations gap; and
- such a requirement might result in companies focusing on compliance at the expense of the substantive assessment and management of risk.

The evidence also suggested that the benefits associated with the original Turnbull guidance had been achieved, at least in part, because of the absence of prescription. Boards have been required to think seriously and not simply delegate a piece of process to a project team lower down the organisation. It was this top level consideration of control issues, encouraged by the Turnbull guidance, which investors found particularly beneficial. Those companies that have derived most benefit from the guidance appeared to be those that viewed it as good business practice rather than simply a compliance exercise.

We are aware of the significant debate in the US on the impact that section 404 has had on smaller and micro-cap companies and the 'one-size fits all' approach to such companies adopted under PCAOB AS2. However, a survey of company directors conducted for the TRG indicated that some 70% of listed companies with a market capitalisation below £500m considered that the benefits of the Turnbull guidance were greater than or equal to the costs.

In our view, smaller company concerns about internal control reporting in the UK are far less significant than in the US because the Turnbull guidance sets out high-level principles with the aim that any company should be able to apply them in a way that is appropriate to the company's circumstances and proportionate to the risks that the internal control system is intended to address. In addition, there is not an AS2 equivalent requirement for auditors in the UK.

### **Follow-up to the FEE paper *Risk Management and Internal Control in the EU***

The European Federation of Accountants (FEE), of which the Institute is a member, published a Discussion Paper in March 2005 entitled *Risk Management and Internal Control in the EU*. The paper provided a review of best practice amongst companies in risk management and internal control, a review of regulatory developments in the US and EU in response to recent financial scandals, and a survey of regulatory requirements on risk management and internal control in EU Member States.

FEE invited comments from market participants on a number of issues raised in the paper. Responses were received from interested parties including the major audit firms, professional accountancy bodies, national and international auditing and assurance standard setters, internal auditors and risk managers.

FEE also held a Forum roundtable in October 2005 which attracted people from a broader range of backgrounds and experience than respondents to the Discussion Paper. They included individuals from the business and investor communities from a number of European Union Member States, as well as the auditing profession.

FEE has prepared a summary of conclusions based on the comments received, discussions at the Forum and further reflections within FEE since the publication of the Discussion Paper. We understand that FEE has submitted this summary to you.

We note that respondents generally agreed with the comments in the Discussion Paper including the view that it would not be desirable to introduce a European equivalent of section 404 and that Europe should learn from US experience. From the discussions at the Forum roundtable it also appeared that:

- the European Commission does not intend to follow a prescriptive approach to internal control;
- a broad-based approach to internal control which does not focus solely on financial reporting controls is widely supported;
- there is no evidence of demand from investors for public reports on the effectiveness of internal control in Europe;
- investors were more interested in descriptive material about risk management and allowing market demand to lead developments;
- cost/benefit analysis should be carried out to avoid unintended consequences of prescriptive regulations;
- legislation, if any, on risk management should not encourage directors and management to become risk averse; and
- further regulation and disclosure will not stop people who lack integrity from committing crimes.

**The Institute's work on differences in corporate governance between the US and the UK, including some interim findings from UK FPIs in relation to sections 302 and 404.**

The Institute is engaged, as part of our Dialogue in Corporate Governance initiative, on a major project entitled *Beyond the Myth of Anglo-American Corporate Governance* which is concerned with a number of fundamental differences in the corporate governance frameworks of the US and the UK. Details of the Institute's project are available on [www.icaew.co.uk/dialogueincorpgov](http://www.icaew.co.uk/dialogueincorpgov).

In the Consultation Paper on the project *Pressure Points*, we ask a series of questions about the pressures for change that result from differences in corporate governance frameworks. From an internal control perspective, it is noticeable that in jurisdictions such as the UK where there has been little investor pressure for section 404-type requirements, shareholders have greater rights under company law than in the US.

The Institute has also recently started related work to learn from the experiences of UK listed FPIs who are preparing to implement section 404 for their first fiscal year ending on or after 15 July 2006 and who have already implemented section 302. UK FPIs appear to have experienced a number of the same issues as their US counterparts in relation to section 404.

Being in large part driven by the audit requirements of AS2, a significant problem arising from section 404 is the huge emphasis on the creation of documentation and evidencing of processes that management needs to undertake in order to satisfy the auditors. In some instances there has been a need to bring documentation up to date, and additional formality and documentation, where necessary, can bring added rigour to internal processes and be of assistance to directors and senior management. Nevertheless documentation can often become an end in itself which is of little value to the running of the business.

By contrast, it is noticeable that our initial findings indicate that work on implementing section 302 has often been seen as useful in reinforcing good practice, resulting, for example, in:

- enhanced awareness of, and accountability for internal controls within the organisation;
- improvement in group-wide and cross-functional processes;
- acceleration of work to rectify non-significant control weaknesses;
- increased focus on controls over IT systems;
- an appreciation of the necessity of approaching key control identification using a top-down approach.

Focussing the minds of senior executives at group and subsidiary company levels on accountability for key controls and their assessment, as well as greater consideration of the control environment within their companies can often be useful. Companies may have also enhanced their internal reporting procedures upwards to the CEO and CFO to complement their existing internal reporting practices.

It is interesting to note that these benefits have been achieved even though there is no detailed guidance for implementing section 302 and no related audit requirement. It appears that directors have had to adopt more of a principles-based approach to decide for themselves how best to satisfy their reporting obligations. This lends support to our view expressed above under 'Principal comments' that there may be scope to look beyond palliatives to a more fundamental review of the requirements of section 404.

We trust that these comments are useful to you and we look forward to following the results of the SEC roundtable and continuing dialogue on this important topic with SEC Commissioners and staff.

If you wish to discuss our comments in further detail, please do not hesitate to contact myself or Jonathan Hunt, Head of Corporate Governance ([jonathan.hunt@icaew.co.uk](mailto:jonathan.hunt@icaew.co.uk)).

Yours sincerely



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1 April 2005

## Appendix A



Jonathan G. Katz  
Secretary  
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by e-mail: rule-comments@sec.gov

Dear Mr Katz

### **File Number 4-497**

#### **ICAEW SUBMISSION TO THE SEC ROUNDTABLE ON THE IMPLEMENTATION OF SARBANES-OXLEY INTERNAL CONTROL PROVISIONS**

I have pleasure in submitting feedback from the Institute of Chartered Accountants in England & Wales (“ICAEW”) to the SEC roundtable on the implementation of Sarbanes-Oxley internal control provisions. The ICAEW operates under a Royal Charter, working in the public interest, and is the largest professional accountancy body in Europe, with over 126,000 members in business, practice, the public and voluntary sectors and academe.

#### **Credentials**

The ICAEW is a major contributor to international work on internal control as evidenced by:

- our publication in 1999 of the original Turnbull guidance, *Internal Control: Guidance for Directors on the Combined Code*;
- our support to the UK Financial Reporting Council (“FRC”) in the preparation of its 2004 guide *The Turnbull guidance as an evaluation framework for the purposes of Section 404(a) of the Sarbanes-Oxley Act*;
- our project management support to the FRC’s Turnbull Review Group which is currently conducting a review of the Turnbull guidance, with any proposed changes scheduled to take effect from 2006;
- our substantial contribution to the March 2005 discussion paper *Risk management and internal control in the EU*, published by FEE, the representative body of the European accountancy profession; and
- the ongoing work of expert committees of members and practitioners in the areas of PCAOB auditing standards and corporate governance, with a sub-group dedicated to UK/US issues.

## **Observations on implementation of Section 404**

We support the overall objective of Section 404 of securing the commitment of boards, managements and auditors to effective internal control over financial reporting by establishing clear accountability. Substantial improvements in internal control over financial reporting are expected to be achieved as a result.

Nevertheless, our members who are involved in the implementation of Section 404, whether as board members, management or auditors confirm messages that you will hear from many quarters:

- the costs of implementation appear to be disproportionately high in relation to the benefits, especially for smaller entities;
- there are potentially significant unintended consequences, for example if auditors are seen as adding costly bureaucracy rather than valued judgement, the standing and attractiveness of the auditing profession, and ultimately its quality, will be diminished;
- significant levels of non-compliance will place considerable demands on registrants, in terms of disclosure and communication, and on investors, who will need to understand the significance of reported material weaknesses; and
- deferral of implementation for foreign private issuers is welcome but is no substitute for action to make implementation more practical and to provide relief from the '300 investor' rule.

In addition, the ICAEW submitted a comment letter dated 2 March 2005 in response to the Turnbull Review Group's consultation paper of December 2004. We expressed our willingness to learn from forthcoming evidence of Section 404 implementation, particularly as it relates to benefits to investors. Nevertheless, our response did not at this stage support bringing any aspects of UK practice into greater alignment with US requirements. In particular, based on experience to date in implementing Section 404, we supported retaining:

- a high level risk-based approach rather than detailed prescription;
- the existing focus on all controls rather than just controls over financial reporting;
- a private board assessment of effectiveness rather than a published statement; and
- the current level of UK auditor involvement rather than, for example, the introduction of a US-style audit covering both financial statements and internal control over financial reporting.

## **Areas for future consideration**

To summarise our initial views, the implementation of Section 404 appears to require a disproportionate investment in financial reporting. This is an important but, nevertheless, quite narrow area of corporate governance. Other aspects of corporate governance appear to escape scrutiny simply because they fall outside the remit of federal securities legislation and the SEC.

This lack of proportion is evidenced, for example, by the fact that:

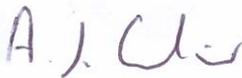
- internal control over financial reporting is only deemed to be effective if the likelihood of material misstatement is remote; and
- registrants are subject to a 'triple' audit covering their internal control over financial reporting, their related statement on effectiveness and their financial statements.

Perhaps the fundamental question facing regulators, politicians, investors and business in the United States is what needs to be done to establish a sense of proportion. Action to make implementation of Section 404 more practical would be welcome. However, any substantive reduction in the financial reporting demands placed on management by Section 404 and related audit requirements may well be dependent on more fundamental changes to build investor confidence in the accountability of management. It is noticeable that in jurisdictions such as the UK where there is little investor pressure for Section 404-type requirements, shareholders have greater rights under company law.

We trust that these comments are useful to you and we look forward to following the results of the SEC roundtable on 13 April and continuing dialogue on this important topic with SEC Commissioners and staff.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely



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PCAOB Chairman William J. McDonough

### **A brief overview of the Turnbull guidance on internal control**

Published in 1999, the principle-based Turnbull guidance to directors of listed companies sets out a framework for delivering and validating internal control for UK listed companies. Turnbull is accepted by the SEC 33-8238 as one of the three named frameworks available for use in connection with section 404(a).

The Turnbull guidance is based on the view that risk is an integral part of business. Improvements in company performance and greater returns for investors are a direct result of measured and successful risk-taking. From a business perspective:

- risk cannot be eliminated but it does need to be properly managed;
- boards and management need to understand the nature and extent of the risks to which the company is exposed, and to manage these within a sound system of internal control;
- information generated internally and used within the organisation for managing the business and executing strategy is also used, in part, for the external disclosures to investors; and
- boards and management therefore need reliable information systems, risk management processes and internal controls that operate effectively, efficiently and economically in order to achieve their internal and external financial and non-financial reporting obligations.

The objectives of the Turnbull guidance are 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 is:

- intended primarily to be an aid to better performance as well as being used to demonstrate compliance with the requirements of the Combined Code on Corporate Governance;
- based on a wide-approach to risk management and internal control and is not limited to internal control over financial reporting;
- not driven by the needs of third party verification and reporting. Responsibility is placed, where it should be, on directors and management.

Under the Listing Rules and existing guidance from the UK Auditing Practices Board, the work of the auditors is limited. Auditors review rather than audit whether a company's published statement on the board's review of internal control is supported by documentation and appropriately reflects the board's process of reviewing the system of internal control. If it does not, the auditors are required to make reference to that fact in their audit report. Further information on the role of external auditors in relation to the Turnbull guidance is provided in Appendix C.

Full details of the revised Turnbull guidance published in October 2005 can be found at [www.frc.org.uk/corporate/internalcontrol.cfm](http://www.frc.org.uk/corporate/internalcontrol.cfm)

### **The role of the auditor in respect of the Turnbull guidance**

#### Background

External auditors are required under the Listing Rules to review the board's compliance statement relating to its review of the internal control system (provision C.2.1 of the Combined Code on Corporate Governance). The Auditing Practices Board (APB) guidance suggests that auditors should evaluate whether the company's published statement on internal control is supported by documentation and appropriately reflects the board's process of reviewing the system of internal control. The auditors will add an additional paragraph to their audit report if they believe that the board's internal control statement is inconsistent with the auditors' knowledge.

In contrast to the requirements in the US under section 404(b) of the Sarbanes-Oxley Act 2002, auditors are not required to issue a statement on the effectiveness of the company's internal control system. The auditor's responsibilities under section 404 relate only to internal controls over financial reporting. In the UK the board's review – and, as a result, the auditor's review of it - covers all types of control.

In reviewing the company's internal control statement, external auditors will also draw on the knowledge of the company that they have obtained during the audit of the financial statements. Under International Standard on Auditing ISA 315, which has been adopted in the UK, external auditors are required to obtain an understanding of internal control relevant to the audit. Internal control as described in the ISA comprises the same components as used in the Turnbull guidance.

#### Turnbull Review Group - evidence, analysis and recommendations

As part of its work in 2004/5, the Turnbull Review Group (TRG) considered whether the existing responsibilities of the external auditors provided value for the board and shareholders, and whether there was a case for those responsibilities to be added to or otherwise changed.

Responses to the TRG's first consultation exercise were consistent on this issue, with similar views being held by business, investors and the accountancy profession. The general view was that the activities of the external auditor in reviewing the company's internal control statement, while limited, provide additional assurance to boards and shareholders and should therefore continue to be undertaken. However, some investors considered that the auditors' oversight role in relation to the internal control statement may inhibit fuller disclosure by the company.

The existing powers and remit of the external auditors were considered sufficient and there was virtually no support for the external auditor's role to be extended; in particular, there was no support for the external auditor being required to attest as to the effectiveness of the company's internal controls.

The main arguments against an expanded role were that it was not appropriate for the auditors to be asked to 'second guess' the board's decisions about how to respond to many non-financial risks that could not be measured against an objective standard, nor were they qualified to do so; and that evidence from the implementation of section 404(b) of the Sarbanes-Oxley Act suggested that there could be significant direct and indirect

costs for the company if the external auditor were required to attest as to the effectiveness of internal controls, particularly as the range of controls covered by the Combined Code and Turnbull guidance was broader than those covered by section 404.

The Review Group agreed with this analysis. There was virtually no demand from investors or companies for an increased role for external auditors, which supported the conclusion that they see at best only limited benefits from an increased role which would not be justified on a cost-benefit analysis. In addition, the Review Group considered it would be inappropriate to require the external auditor to give assurances in respect of the effectiveness of the controls when it is recommending that the board should not be required to do so.

The Review Group therefore recommended that there should be no expansion of the external auditors' responsibilities in relation to the company's internal control statement.