<table>
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<tr>
<th><strong>Title</strong></th>
<th>Turnbull puts Risk Management to the Top of Corporate Agendas</th>
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<td><strong>Authors(s)</strong></td>
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Introduction

Corporate governance deals with the way in which businesses are run. Issues of corporate governance have attracted special attention during the 1990s in response to major corporate scandals. Subsequent deliberations of the Cadbury and other committees has led to substantial increases in Stock Exchange regulations on corporate governance. Under Stock Exchange regulations, directors’ reports must deal with various aspects of corporate governance, including directors’ responsibilities, audit committees and remuneration committees.

Companies Legislation

Legislation makes little or no provision for issues of corporate governance. Section 195 of the Companies Act 1963, as amended by section 51 of the Companies (Amendment) Act 1990, requires companies to keep a register of directors and section 59 requires a register of directors’ interests to be kept.

Directors have responsibilities under company law, although these responsibilities are not well specified by legislation. Case law is looked to for more specific guidance on directors’ duties. Duties of directors are, under section 52 of the Companies (Amendment) Act 1990, owed to employees as well as members of companies.

Development of Principles of Corporate Governance

Table 1 summarises the chronology of the main stages in the development of principles of corporate governance.
Table 1: Chronology of developments in corporate governance

<table>
<thead>
<tr>
<th>Report</th>
<th>Issue</th>
<th>Date</th>
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<tbody>
<tr>
<td>Cadbury Report</td>
<td>Corporate governance principles</td>
<td>December 1992</td>
</tr>
<tr>
<td>Rutteman Guidance</td>
<td>Internal control and financial reporting</td>
<td>December 1994</td>
</tr>
<tr>
<td>Greenbury Proposals</td>
<td>Executive remuneration</td>
<td>July 1995</td>
</tr>
<tr>
<td>Hampel Report</td>
<td>Corporate governance principles</td>
<td>January 1998</td>
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<tr>
<td>Combined Code</td>
<td>Corporate governance principles</td>
<td>June 1998</td>
</tr>
<tr>
<td>Turnbull Report</td>
<td>Internal control</td>
<td>September 1999</td>
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</table>

In 1991 a committee, under the chairmanship of Sir Adrian Cadbury, was set up jointly in the UK by Financial Reporting Council, the Stock Exchange and the accountancy profession. The Cadbury report\(^1\) was published in 1992. Although much of the work in developing the code of best practice took place in the UK, it was applicable to Irish publicly listed companies (plcs).

The report contains a code of best practice listing 19 recommendations, of which 17 were effective from June 1993. Two recommendations, on going concern and internal control, could not be implemented until the accounting profession developed the necessary guidance for directors. A joint working group (the Rutteman Group) was established for this purpose and appropriate guidance on internal control was issued in December 1994\(^2\).

In January 1995 the Confederation of British Industry appointed a committee under Sir Richard Greenbury to identify good practice and prepare a code for plcs in determining directors’ remuneration. The Greenbury report\(^3\) was published in July 1995. Much of the Greenbury code of best practice was incorporated into the Stock Exchange listing rules.

In December 1995 the successor to the Cadbury committee was announced under the chairmanship of Sir Ronald Hampel. The Hampel committee’s remit extended to

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listed companies only. Responsibilities of the committee included:

- Review of the Cadbury code and its implementation;
- Review the role of directors;
- Pursue relevant matters arising from the Greenbury committee;
- Address the role of shareholders and auditors in corporate governance issues.

The Hampel Committee published its report\(^4\) in January 1998. In addition, it decided to produce a Combined Code\(^5\) for incorporation into the Stock Exchange listing rules to embrace (i) the Cadbury code, (ii) the Greenbury recommendations and (iii) its own report.

The final piece of the corporate governance jigsaw, guidance on internal control (Turnbull Report\(^6\)), was issued in September 1999. This guidance is to assist directors in the review of internal control as required by the Combined Code.

**Recommendations of the Combined Code of Best Practice**

The Combined Code sets out principles of good corporate governance which are summarised in Table 2. It has been appended to, but does not form part of, the stock exchange listing rules. The Combined Code consists of 17 principles in two parts: the first part contains 14 principles which apply to companies and the remaining three principles in the second part apply to institutional shareholders. These 17 principles are supplemented by 48 Code provisions.

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### Table 2: Principles of Good Corporate Governance – the Combined Code

<table>
<thead>
<tr>
<th>A. Directors and the Board</th>
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<tbody>
<tr>
<td>1. Effective board to lead and control the company</td>
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<tr>
<td>2. Running the board and running the company are separate tasks</td>
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<tr>
<td>Clear division of responsibilities at the head of the company</td>
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<tr>
<td>No individual has unfettered powers</td>
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<tr>
<td>3. Balance of executive and non-executive directors</td>
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<tr>
<td>No individual or group to dominate the board</td>
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<tr>
<td>4. Timely and quality information to the board</td>
</tr>
<tr>
<td>5. Formal and transparent procedures for appointments to the board (nomination committee)</td>
</tr>
<tr>
<td>6. Directors re-elected at least every three years</td>
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<table>
<thead>
<tr>
<th>B. Directors’ remuneration</th>
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</thead>
<tbody>
<tr>
<td>1. Remuneration to attract and retain but no more than necessary</td>
</tr>
<tr>
<td>Executive remuneration partly linked to corporate and individual performance</td>
</tr>
<tr>
<td>2. Formal, transparent procedure for developing policy and individual packages (remuneration committee)</td>
</tr>
<tr>
<td>Directors not involved in deciding their own remuneration</td>
</tr>
<tr>
<td>3. Statement of remuneration policy and details of the remuneration of each director to be disclosed</td>
</tr>
</tbody>
</table>

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<tr>
<th>C. Relations with shareholders</th>
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<tbody>
<tr>
<td>1. Encourage dialogue on objectives with institutional shareholders</td>
</tr>
<tr>
<td>2. Annual general meeting to communicate with private investors and encourage their participation</td>
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</tbody>
</table>

<table>
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<tr>
<th>D. Accountability and audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Balanced and understandable assessment of the company’s position and prospects</td>
</tr>
<tr>
<td>2. Sound system of internal control</td>
</tr>
<tr>
<td>3. Formal transparent system to apply above two principles and maintain relationship with auditors (audit committee, with at least three non-executive directors)</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>E. Institutional investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Responsibility to make considered use of their votes</td>
</tr>
<tr>
<td>2. Preparedness to enter dialogue on objectives with the company</td>
</tr>
<tr>
<td>3. Evaluation of companies’ governance arrangements, particularly board structure and composition</td>
</tr>
</tbody>
</table>

Source: *Principles of Good Governance and Code of Best Practices* (the Combined Code)

Principle D2 is the focus of this article and is the subject of the Turnbull recommendations.

Paragraph 12.43A of the stock exchange listing rules in effect implements the Combined Code by requiring two matters to be disclosed in annual reports:

- How the company applies the principles of the Combined Code;
- Whether or not the company complies with the detailed provisions of the Combined Code, with an explanation for exceptions;

Further guidance on the Combined Code requirements concerning internal control is provided by the Turnbull Report.
Internal control

Recommendations on directors’ responsibilities concerning internal control were first included in the Cadbury Report which stated:

‘Directors should report on the effectiveness of the company’s system of internal control and the report should be audited.’

The Cadbury Report expanded on this requirement by specifying that the statement should contain at a minimum:

- Acknowledgement by the directors that they are responsible for the company’s system of financial control;
- Explanation that such a system can provide only reasonable and not absolute assurance against material misstatement or loss;
- Description of key procedures that the directors have established and which are designed to provide effective internal financial control; and
- Confirmation that the directors (or a board committee) have reviewed the effectiveness of the system of internal financial control.

The more recent Combined Code now requires company boards to review the effectiveness of all controls, not just financial controls. This requires boards and audit committees to consider the company’s approach to evaluating risk. The Combined Code significantly expands the risks to be considered beyond the more narrowly defined financial risks referred to in the Cadbury Report. Principle D2 of the Combined Code states:

‘The board should maintain a sound system of internal control to safeguard shareholders’ investments and the company’s assets’.

The term ‘internal control’ is defined in the Turnbull Report (Ibid. para. 20) as:

‘...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.’
Principle D2 is supplemented by two Code provisions. Provision D2.1 specifies that:

- Directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal control;
- Directors should report to shareholders that they have so done;
- The review should cover all controls, including financial, operational and compliance controls and risk management.

Finally, provision D2.2 requires boards of companies without an internal audit function to review from time to time the need for one.

**Turnbull Report**

The Institute of Chartered Accountants in England and Wales (ICAEW) issued guidance on how companies should implement the internal control provisions of the Combined Code. The guidelines were produced by an ICAEW working party chaired by Sir Nigel Turnbull, finance director of the Rank Group.

The working party was forced to balance two competing demands of the Combined Code. On the one hand, the Combined Code considerably expanded the requirement on companies to report, recommending that they disclose information on their internal control provisions relating to all ‘significant business, operational, financial, compliance and other risks’. Previously companies were asked to report just on financial controls. On the other hand, the Combined Code stressed that disclosure requirements should be less prescriptive and lead to more meaningful disclosure.

The working party tried to find ways of broadening the scope of internal control while trying to ‘avoid simply overlaying existing practice with an additional layer of regulatory requirement.’

A risk-based approach underpins the recommendations. The issue of internal control has been linked with the wider issue of risk management. Internal control is seen as an organic element of the business ‘within its normal management and governance processes’ not ‘as a separate exercise undertaken to meet regulatory requirements’.
Turnbull requires companies to recognise risks across the whole spectrum of business. Risks related to market position, credit, legal issues, health and safety, information technology and liquidity are some of the categories to be considered. Specially tailored internal control systems must be established to manage company’s overall risk exposure. Companies are required to carry out a continuous assessment of the internal control system throughout the financial year (not just once a year). The Turnbull Report calls for risk control to be ‘embedded within the business’, part and parcel of everyday activity.

Recommendations of the Turnbull Report are presented under four headings and are summarised as follows.

*Maintaining a Sound System of Internal Control*

Under the Turnbull guidelines, boards are ultimately responsible for the system of internal control. However, they will normally delegate the establishment, operation and monitoring of the system of internal control to management. Boards must seek regular assurance that the system of internal control is functioning effectively and is effective in managing company risks. In so doing, boards should consider the following factors:

- Nature and extent of the risks facing the company;
- Extent and categories of risks regarded as acceptable;
- Likelihood of the risks concerned materialising;
- Company’s ability to reduce the incidence and impact of risks that do materialise;
- Costs and benefits of managing risks.

Managements are required to design, operate and monitor a suitable system of internal control which implements board policy. Employees also have some responsibility for internal control.

Company internal control systems should:

- Be embedded in the operations of a company;

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• Be able to respond to the changing risks within and outside the company;
• Enable each company to apply it in an appropriate manner related to its key risks.

**Reviewing the Effectiveness of Internal Control**

Boards are required by the Turnbull Report to form their own view on effectiveness after due and careful enquiry. Boards should define the process to be adopted for their review of the effectiveness of internal control. When reviewing management reports on internal control, the board should:

• Consider the significant risks, and how they have been identified, evaluated and managed;
• Assess the effectiveness of the internal control system in managing significant risks;
• Consider whether necessary actions are being taken to remedy any significant failings or weaknesses;
• Consider whether there is a need for more extensive monitoring of the system of internal control.

**Board Statements on Internal Control**

The Turnbull Report requires boards to make statements on how companies have implemented its requirements. The disclosures to be made in board statements are extensive and are summarised in Table 3. Boards must ensure that the disclosures provide meaningful high-level information and do not give a misleading impression.
Table 3: Disclosure requirements of the Turnbull Report

- There is an ongoing process for identifying, evaluating and managing the company’s key risks*
- The process has been in place for the year under review and up to the date of approval of the annual report and accounts*
- The process is regularly reviewed by the board*
- The process complies with the Turnbull Report guidance*
- Additional information may be provided to assist understanding of the risk management processes and system of internal control (optional)
- Acknowledgement that the board is responsible for the system of internal control and for reviewing its effectiveness
- Explanation that the system is designed to minimise rather than eliminate risk of failure to achieve business objectives
- Explanation that system can only provide reasonable assurance against material misstatement or loss
- Summary of the process applied in reviewing the effectiveness of the system of internal control
- Process applied to deal with any significant internal control problems disclosed in the board statement*
- Where disclosure (of items marked *) is not possible, a statement and explanation of this fact
- Failure to review the effectiveness of the system of internal control (where applicable)
- Disclosure, where the guidance has not been applied in respect of material joint ventures and associates
- Adoption of transitional provisions (where applicable)
- Disclose if the board has not reviewed the need for an internal audit function (where one does not exist)


**Internal Audit**

In the absence of an internal audit function, boards should assess the need for such an internal audit function. Where there is an internal audit function, its scope, authority and resources should be reviewed by the board at least annually.

**Implementing the Turnbull Report**

Full compliance with the guidance is expected in respect of accounting periods ending on or after 23 December 2000. However, to give companies time to take the necessary steps to adopt the new guidance, transitional provisions apply for accounting periods ending on or after 23 December 1999 and up to 22 December 2000. At a minimum, (i) a statement that the procedures necessary to implement the guidance have been established (or an explanation of when such procedures are expected to be in place)
and (ii) a report on internal financial controls should be included in the annual report. Where the transitional approach is adopted a statement to this effect must be disclosed.

**Adoption of the Turnbull Provisions**

According to the Strategic Planning Society⁹ in the UK, three main strategy responses to Turnbull by companies are emerging:

- Prescriptive compliance: minimal compliance with external regulation;
- Problem focus: concentration on areas of poor risk performance or changes in context, given the existing system of internal control;
- All-risks review plus robust risk management system: validation of a risk focus and controls in order to strengthen business strategy and enhance shareholder value.

Most Irish companies, such as Arnotts and Waterford Wedgwood below, are opting for the transitional provisions of the Listing Rules. The extract on internal control from Arnotts’ (Example 1) directors’ report tends to refer to financial controls only. The board of Arnotts comments that a review of the effectiveness of the system of internal control took place without going into any details of what that review entailed.

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Example 1: Board statement on internal control
Arnotts plc year ended 31 January 2000

Report of the directors (extract)
Statement of Directors’ Responsibilities (extract)

Internal Control
In accordance with the transitional arrangements which apply in respect of compliance with principle D.2 of the Code on internal control the Board has decided that for the year ended 31 January 2000 it will continue to report on internal financial control pursuant to the guidance for directors on internal control and financial reporting that was issued by the Rutteman Working Group in December 1994.

The Board has studied the recommendations of the Turnbull Committee published on 27 September 1999 and anticipate that procedures will be in place to adopt them fully during the last quarter of 2000.

The Board of Directors has overall responsibility for the group’s system of internal financial control and has established systems of internal control which the directors believe to be appropriate to the business.

The systems of internal financial control are designed to provide reasonable but not absolute assurance against material mis-statement or loss. They include:
- Comprehensive budgeting systems with an annual budget approved by the Board;
- Regular consideration by the Board of actual results compared with budget;
- Clearly defined capital investment control guidelines and procedures set by the Board;
- Regular reporting of legal, treasury and accounting developments to the Board.

The directors through the Audit Committee have reviewed the effectiveness of the group’s system of internal financial control.

Waterford Wedgwood (Example 2) describes in more detail the steps being taken to ensure that it can comply fully with the requirements of the Turnbull Report in one year’s time. The directors’ report states that under the transitional provisions only internal financial controls are reviewed, but the directors indicate that the review will be broadened to an expanded internal control system including not just financial risk management, but also operational and compliance risk management.
Example 2: Board statement on internal control
Waterford Wedgwood year ended 31 December 1999

Report of the Director
Corporate Governance
(iii) Turnbull guidance on internal control
Published in September 1999, the Turnbull report was intended to provide
guidance to directors on implementing the Stock Exchange Listing Rules as they
relate to internal control.
The Combined Code of The Stock Exchange Listing Rules states:-
1. That the Board should maintain a sound system of internal control to
   safeguard shareholders’ investment and the Company’s assets.
2. That the Directors should, at least annually, conduct a review of the
effectiveness of the Group’s system of internal control and should report that
they have done so.
The review should cover all controls, including financial, operational and
compliance controls and risk management.
The Board of Waterford Wedgwood has had in place for many years an
established system for reviewing the internal financial controls of the Group
through an internal audit system and Audit Committee process. Following the
publication of Turnbull, the Board has established a process to comply with
Turnbull which involves a broadening of internal controls to include not just
financial risk management but also operational and compliance risk management.
It is intended that this expanded internal control system which will address the
nature and extent of the risks facing the Company will form part of the culture of
the Group and will be fully established by 30 June 2000. The Directors have
therefore elected to take advantage of the Irish Stock Exchange’s transitional
rules and have continued to review and report upon internal financial controls for
the year ended 31 December 1999 in accordance with the 1994 guidance, Internal
Control and Financial Reporting (the Rutteman Guidance).

Controlling legal risk
Across all categories of risk, the most obvious way to manage a risk is to transfer it –
for many risks this means traditional insurance. However, risk transfer may not be the
most effective course of action - many risks cannot be addressed or transferred
through insurance. Uninsurable risks present the real management challenges.
Corporate strategy should be to reduce such risks as much as possible, subject to cost
benefit considerations.

Risk management can no longer be seen in terms of financial risk alone. Many risks
have a legal basis. The Turnbull Report recognises that one of the key issues to a
sound system of internal control is controlling legal risk. It is predicted\(^\text{10}\) that lawyers
and other professionals will, in conjunction with the annual financial audit, assess

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internal contractual relationships and how risk is shared between parties such as customers, suppliers, regulators, employees and consumers. Lawyers will have a major role to play in other elements of controlling risk such as sharing of risks through joint ventures, contingency planning and the avoidance of unplanned risk taking. Risk management advice is not simply the preserve of accountancy firms and insurance companies. Increasingly, legal practices will provide clients with risk advisory services. One such firm is Eversheds in the UK which offers clients business risk services which (the firm says) can reduce the risk of disputes, enhance external and internal relationships, ensure compliance with customer and joint venture requirements, increase the prospects of insurance recovery, contribute to a safer working environment, protect corporate image, brands and reputation. The head of Eversheds’ Business Risk Services says ‘While other advisers also give their clients strategic advice, lawyers can also do something about it – by structuring a transaction or drafting contractual provisions to transfer or limit risk, by registering a trademark or establishing an employee disciplinary procedure and so on.’

Other legal implications of the Turnbull recommendations have been flagged. For example, it is likely that courts will hold that failure to adopt and comply with the guidance, will be evidence of failure to comply with the requisite standards of behaviour (in the absence of good reasons to the contrary). Companies are warned to take care in preparing reports on all aspects of internal control as these could be subject to disclosure during litigation.

Concluding Comments
A side effect of the Turnbull requirements is that plcs will want to see risk management policies in place in their supplier and customer firms and in other organisations with which they have contractual relationships. Although the Combined Code, and related Turnbull Guidance, apply only to plcs, these requirements are likely to have a trickle down effect and, in time, affect the management of risk in private and public sector companies.

11 Eversheds, 1999, ‘Eversheds launches business risk services for clients in the private and public sectors’, www.eversheds.co.uk/pr/19991101-1.htm