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Mr N Peace
Secretary
Committee on the Financial Aspects
of Corporate Governance
PO Box 433
Moorgate Place
London EC2P 2BJ

Your ref	Our ref	Direct line	Telex	Date
	BTO'D/TAT/L3.JUL	071-798 5861	5861	31 July 92

Dear Mr Peace

I am pleased to have the opportunity of commenting on the draft report on Financial Aspects of Corporate Governance and enclose my comments with this letter.

The principal issues arising cover the following three areas:

1. Terms of Reference

The Committee's terms of reference appear to be too narrow to meet the expectations of most people which have focussed on failures of major companies and fraud at the highest levels of management. It is often not clear in the report whether the Committee is addressing corporate governance in its widest sense or just the aspects of corporate governance that relate to the publication of financial statements.

2. Internal (Financial) Control

The distinction between the term "internal control" and "internal financial control" is important. The report uses both these terms. They need to be defined and the report needs to be reviewed to ensure that the correct terms have been used.

/.....

3. Internal Audit

Internal audit plays an important part in maintaining good corporate governance and the audit committee would have difficulty in fulfilling its responsibilities without the support of an effective internal audit function. The absence of a regular review process would itself represent a serious weakness in internal control. The report omits a valuable recommendation that it should be regarded as best practice for listed companies to have an effective internal audit function.

If you would like to discuss any of the attached comments please give me a call.

Yours sincerely

A handwritten signature in black ink, appearing to read "B. T. O'Driscoll", written over a horizontal line.

B T O'Driscoll
Group Chief Internal Auditor

**COMMENTS ON DRAFT REPORT ON
FINANCIAL ASPECTS OF CORPORATE GOVERNANCE**

1. The Committee's Terms of Reference.

- 1.1 The committee was set up because of the perceived low level of confidence both in Financial Reporting and in the ability of auditors to provide the safeguards which the users of Company Reports sought and expected. These concerns were heightened by unexpected failures of major companies, criticism of excessive pay increases for top management and the ineffectiveness of existing systems for preventing failures or controlling directors' pay.
- 1.2 In this context, the committee's terms of reference are narrow. They are "to consider issues in relation to financial reporting and accountability...". There is no mention of 'corporate governance'. There is, nevertheless, a public expectation that the committee should address the problems associated with failures of corporate governance and this expectation is acknowledged by the committee in paragraphs 2.1 - 2.4.
- 1.3 Against this public expectation, it is doubtful if the draft report will succeed. It is not clear whether the proposed Code of Best Practice addresses only financial controls which relate to the financial statements or whether it is intended to address all controls that affect corporate governance in its widest sense. The codes 1.1 to 1.4 relating to the Board of Directors cover wider control issues but 4.2 to 4.6 relating to Controls and Reporting address control issues relating to financial statements only.

2. Definition of Corporate Governance

The report does not contain a useful definition of 'corporate governance' or 'financial corporate governance'. It would give the report more substance and help the debate if it included a discussion on and definition of these terms.

3. Statement of Compliance

Guidance should be given on the content and form of the statement of compliance. It is not appropriate for auditors to review the compliance statement made by management other than on questions of fact. For example, the existence of an Audit Committee or the length of Directors' service contracts can be verified but it would not be appropriate to review whether the Board has ensured that an objective and professional relationship has been maintained with the auditors.

4. Internal (Financial) Control

4.1 The report uses the phrases "internal control" and "internal financial control". The wording of the report should be scrutinised so that the correct wording is used in each instance and the risk of misunderstanding avoided. For example, "Internal Control" is used in:

- . Paragraph 4.25: "There is..... an implicit requirement on directors to ensure that a proper system of internal control is in place."
- . Summary of recommendations 11: "The accountancy profession.. should draw up criteria for accessing effective systems of internal control..."
- . Appendix 3 Annex "Specimen Terms of Reference for an Audit Committee" - 9: "to keep under review the effectiveness of internal control systems,...."

and "Internal Financial Control" is used in:

- . 4.26 "directors in their Report should make a statement on the effectiveness of their system of internal financial control".
- . 5.16 ".... directors should report on the effectiveness of their system of internal financial control...."

4.2 The distinction between these terms is important. In the examples quoted we have on the one hand a recommendation that the accountancy profession should draw up criteria for assessing effective systems of internal control and on the other hand directors making a statement of the effectiveness of their system of internal financial control.

4.3 In these and other examples, the report should be clear whether it means internal control, internal financial control, or internal accounting control. It would help if these terms were defined in the report.

5. Internal and External Audit

It would aid clarity if the committee used the phrase "external auditors" or "outside auditors" when this is meant rather than just "auditors". This would highlight the difference in the role between internal and external audit and avoid confusion where the meaning could apply to internal auditors.

6. Requirement for Internal Audit

6.1 The Code requires Boards to establish effective audit committees and to make a statement on the effectiveness of their system of internal financial control. It is also recommended that (external) auditors should report on this statement. The report does not sufficiently reflect the role of internal audit in maintaining good corporate governance.

6.2 Internal audit is already mandatory, or virtually so, in central and local government, state financed agencies, banks, building societies and some other financial institutions. Corporate governance would be strengthened in other listed companies if the Code of Best Practice included the establishment of internal audit departments which should report to the audit committee on the effectiveness of the system of internal control (not just financial internal control).

6.3 Internal audit often undertakes reviews of controls as a monitoring process for management. This activity is an essential component of internal control and the absence of it would result in an inadequate system of internal control.

6.4 An effective internal audit function will have responsibility for reviewing all key controls of the company/group in a specified period. Normally, a "rolling" 3 or 4 year plan will be drawn up and the Chief Internal Auditor will report to the Audit Committee progress against plan, any major findings and how management has responded to recommendations.

- 6.5 The internal auditor must work closely and in co-operation with the external auditor to avoid unnecessary duplication of work and so that each can rely on the work of the other to fulfil their responsibilities. The Audit Committee should ask the external auditors about the performance of the internal audit function and obtain assurance from the Chief Internal Auditor that the combined work of internal and external audit provides adequate audit coverage of all key controls.
- 6.6 The report concentrates too much on the issues of corporate governance through the eyes of the external auditor. The external auditor's responsibility is to report on a set of financial statements which relates to the state of affairs of a company at a point in time. It does not recognise the need for continuous monitoring of internal controls. Effective corporate governance is achieved by regular ongoing review and evaluation which is itself an essential part of the internal control process.
- 6.7 The positive role played by internal audit is strengthened by the internal audit department's independence (of management) and the objectivity of internal audit. This independence permits internal auditors to render impartial and unbiased judgements and opinions upon which the Audit Committee must rely for its role of monitoring corporate governance. It is therefore suggested that the second sentence of 4.30 should be extended to include "and on being supported by a strong independent internal audit function".
- 6.8 The practice of good corporate governance will certainly improve if the role of internal audit is recognised and reinforced by the inclusion in the report of the following recommendations:
- a) that the Chief Internal Auditor should respond either to the Chief Executive or to the Chairman of the audit committee.
 - b) that internal audit should be independent of management and objective in its reporting, with authority to have access to any system, information or personnel during its investigations.
 - c) that the internal audit function should conduct its work in accordance with the code of ethics and professional standards of the Institute of Internal Auditors.

- d) that the Audit Committees duties should normally include endorsement of the appointment of the head of internal audit and recommendations to the Board on any questions of resignation or dismissal.

The following amendments are also suggested:

- i. In 4.29, third bullet point: the words "if applicable" should be deleted (see also Appendix 3 - 6(c)).

Fifth bullet point, fourth 'dash': this should be extended to read "review of the internal audit programme, any significant findings of internal investigations, how management has responded to internal audit recommendations, and the opinion of the Chief Internal Auditor on the adequacy and effectiveness of the company's system of internal control". (Similar wording should also go in the specimen terms of reference, Appendix 3.)

- ii. In 4.31, 1st sentence: after "complementary to" add "but different from". The former phrase suggests that internal audit is much like external audit, but done internally. This is not the case. Internal audit normally has responsibility for reviewing all controls not just financial/accounting controls.

2nd sentence: delete "both an aid to" and replace with "an essential part of".

2nd sentence: delete "and limits the amount of external audit work which is required".

Last sentence: full stop after "internal auditors".
New last sentence to read "We regard it as essential that heads of internal audit should have unrestricted right of access to the chairman of the audit committee in order to ensure the independence of their position."

- 6.9 The report omits a valuable recommendation that it should be regarded as best practice for listed companies to have an effective internal audit function whose reporting line should be independent of line management.

7. Detailed comments on the Code of Best Practice

Code

- 1.2 The suggestion that there should be an appointed leader is incompatible with a unitary board system.
- 3.2 Does the reference to "Directors' total emoluments" include non-executive directors as well as executive directors?
- 4.1 The establishment of effective Audit Committees is supported. However, the report should make it clear that the Audit Committee is a sub-committee of the board and is acting on behalf of the board in its responsibility for reviewing the state of internal control in the company.
- 4.2 There is a clear need for a definition of "internal financial control" and it is necessary to determine what criteria are to be used to ascertain whether a system of "internal control" or "internal financial control" is effective.
- 1.3 These statements are too general to be able to judge
2.1 whether compliance is taking place.
4.3
- 4.4 This statement is also too general and needs to be expanded to describe what constitutes a balanced and understandable assessment of the company's position.
- 4.7 This code should include a reference to the matters on which the Chairman of the audit and remuneration committee should answer questions.