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Thought leadership from the Institute…

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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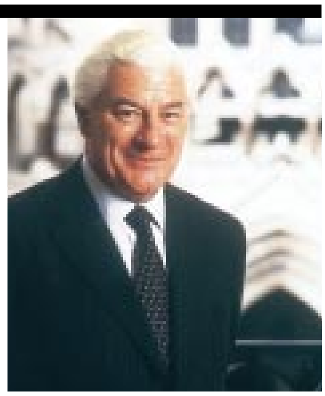
Foreword



With the finalisation of the guidance on internal control developed by the Working Party led by Nigel Turnbull, the last piece of the Combined Code is ready to be put in place by listed companies subject to its principles and provisions.

For directors, the task ahead is to implement control over the wider aspects of business risk in such a way as to add value rather than merely go through a compliance exercise. There is also a need to get the buy-in of people at all levels of the organisation and to focus on risk management and internal control in such a way as to improve the business.

The briefing, which Martyn Jones and Gillian Sutherland have developed with input from other people knowledgeable in the practicalities of risk management and internal control, is not intended to be further authoritative guidance which directors have to follow. Instead, it aims to be a source of timely, practical help to those directors who wish to take steps to implement the new guidance in a straightforward way which brings business benefits. I commend it particularly to directors of smaller listed companies.

We are now in an era when more focus can be placed on gaining business advantage from good governance practices. The new guidance relating to internal control, and this briefing, should help in this area.

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The Institute of Chartered Accountants
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September 1999

Contents

Executive Summary

If you are a director of a company which is listed on the London Stock Exchange, or is considering a listing, the guidance on internal control issued by the Working Party chaired by Nigel Turnbull should be near the top of your agenda. The purpose of this briefing is to set out a number of questions which you could be asking and some practical steps which you could take to meet the Working Party's recommendations.

This briefing has been prepared for directors who wish to take straightforward steps towards achieving Turnbull or are interested in the practicalities of good risk management and internal control and in getting added value for their companies from the guidance. It may be of particular use to smaller listed companies and a number of the case studies, hot tips and examples which it contains are prepared with such companies in mind. It is assumed that readers will also study the Working Party's guidance in full and therefore does not go into the detail of the guidance. Indeed, this briefing should be read in conjunction with the guidance. However, the briefing does guide you through the issues raised when complying with Turnbull.

The key messages are as follows:

- Do not delay in implementing Turnbull
- Obtain management buy-in at all levels of the organisation
- Prepare a plan
- Identify clear company objectives
- Prioritise the risks to the achievement of the objectives
- Establish a clear risk management policy and control strategies
- Consult throughout the business
- Improve the business culture where appropriate
- Keep it simple and straightforward
- Monitor continuously
- Avoid audit committee overload
- Incorporate Turnbull in your management and governance processes
- Aim to obtain business improvement

Clearly the process that needs to be followed must fit the circumstances of the company. Directors may therefore decide that only some of the suggested practices are appropriate to their circumstances. This briefing is not intended to suggest that the practices described should be adopted in their totality.

1. Why Turnbull?

1.1 Benefits and consequences

What is the Turnbull guidance really about?
The guidance is about the adoption of a risk-based approach to establishing a system of internal control and reviewing its effectiveness. It is needed not just for London Stock Exchange purposes, but because it makes sound business sense to manage risk effectively and to embed internal control in the business processes by which a company pursues its objectives.

Will the introduction of Turnbull result in more bureaucracy and overhead?
If you turn it into just a box ticking exercise with no linkage to the possibility of improving your business, yes it could result in more bureaucracy and cost. However, if you are interested in using Turnbull as a powerful mechanism which can improve your business and your financial results, read on.

> Benefits of early action could be considerable in terms of competitiveness, flexibility and new opportunities not just the potential for reduced costs from fewer risk exposures.

What are the potential benefits of effective risk management and internal control?
Directors are concerned with the long term direction of their company. They need to set goals (or objectives), with varying timeframes. “Risks” can mean that a company’s realised goals are very different from its intended, desired goals. Therefore, as risk can have a large impact on how a company performs, it should be of prime concern to all directors.

A risk-based approach can make a company more flexible and responsive to market fluctuations making it better able to satisfy customers’ ever-changing needs in a continually evolving business environment. Companies can gain an early-mover advantage by adapting to new circumstances faster than their rivals, which again could lead to competitive advantage in the medium and long term.

External perceptions of a company are affected by the level of risk that it faces and by the way its risks are managed. A major risk exposure and source of business failure and/or lack of opportunity success has been the failure to manage change. Companies need to be aware of changing markets, service delivery (e.g. e-commerce) and morale. Effective risk management and internal control can be used to manage change, to involve all levels of people in the company in meeting its business objectives, and to improve a company’s credit rating and ability to raise funds in the future, not to mention its share price over the longer term.

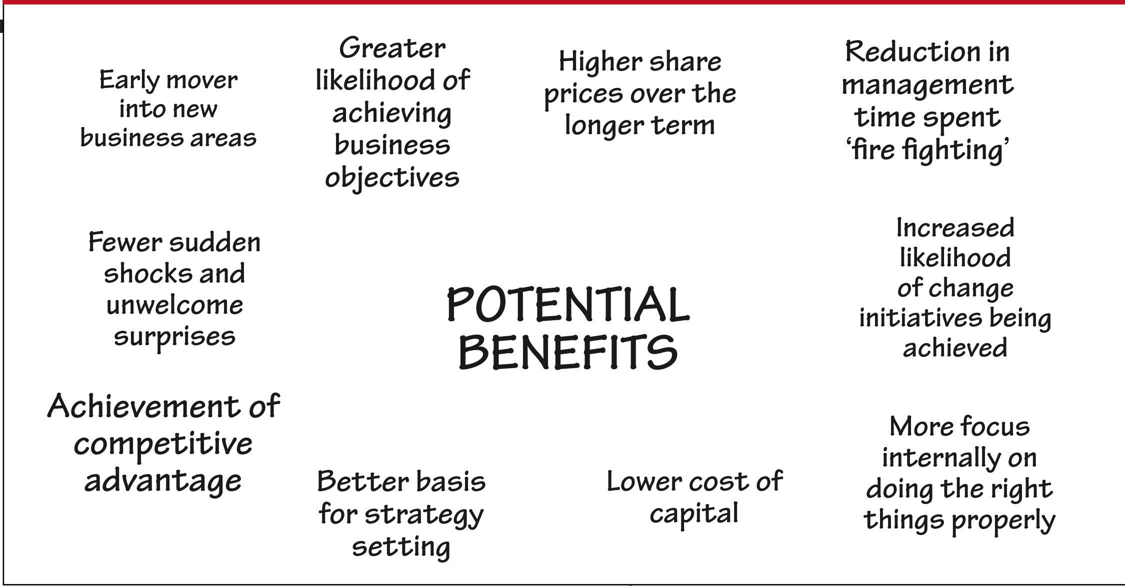
Therefore, the proper focus on risk management and internal control can result in considerable benefits being gained by a company. Some of these are summarised in figure 1 over the page.

There are few benefits to be gained from treating effective risk management and internal control as merely a regulatory requirement.

> Successful companies should consider the full implications of the Turnbull recommendations. They must not be blinded by their own success, since the next surprise may be just around the corner!
> DO NOT GET COMPLACENT.

What are the consequences of non-compliance?
The Turnbull guidance is linked, via the Combined Code on Corporate Governance, to the Listing Rule disclosure requirements of the London Stock Exchange. Consequently, non-compliance with the Turnbull guidance would result in an embarrassing disclosure in the annual report which could attract the attention of the press, shareholder activists and institutional investors.

Figure 1 Potential benefits of effective risk management and internal control



The main downside, however, really comes in the form of a missed opportunity. That opportunity, which is being grasped by other companies, is to use the Turnbull guidance to help fulfil the company's objectives (be they growth, business survival, controlling the cost base or other commercially focused objectives) and to reduce the possibility of unwelcome events occurring.

1.2 Smaller companies

Is risk management and the Turnbull guidance relevant to the smaller listed company?

The answer is definitely yes. Indeed, it is arguable that an assessment of the effectiveness of the system of internal control is particularly relevant to a smaller listed company. The level of risk to which such a company is exposed is generally increasing. Gaining and then sustaining a high market capitalisation depends amongst other things on demonstrating to investors that there is effective risk management and internal control.

Small companies normally have advantages over their larger counterparts when trying to implement a major change strategy such as that required if risk management is to be adopted wholeheartedly. Such advantages can be as follows:

- Small companies are frequently young and flexible enough to adapt their culture. Also, since they are frequently learning, keen to gain an edge over competitors and not encumbered by the bureaucracy sometimes associated with larger companies, they can accomplish the necessary changes with minimum disruption.
- Adopting risk management early can mean that small companies could reduce the costs of transition once they have grown or been hit by an unforeseen event. The foundations laid by risk management mean that they will gain advantage over competitors who wait for an unpleasant surprise to convince themselves of the merits of risk management. It also means that the risk management culture will become ingrained in everything that the company does as it grows.

Other features of a smaller listed company which can significantly assist effective risk management and internal control may include:

- **a high level of board cohesion;**
- **frequent meetings between the board members;**
- **small, highly committed teams;**
- **a high level understanding of, and a focus on, a small number of business activities;**
- **a tight control of risks relating to survival;**
- **a strong focus on cash management; and**
- **a culture of risk taking.**

2. How to add value

2.1 Linking risk and control with business objectives

Risk management and internal control are firmly linked with the ability of the company to fulfil clear business objectives. Risk management can be used to reinforce, on an ongoing basis, what senior management and the board are seeking to achieve.

It is important that managers get out of an 'only downside risk' mentality. Risk is not only 'bad things happening', but also 'good things not happening'. Companies are now seeing opportunities from focusing on risk and control, rather than purely focusing on controls.

Case Study No. 1

White plc is a niche business which is noted for its traditional values but unspectacular performance. Internal control was seen as necessary in the financial and compliance areas.

A top down approach to risk management was introduced. This began with a two hour session, at which the managing director, the operations director and the compliance director identified, for the next two years, the external business drivers, the significant risks and the principal gaps in the control system. The opportunity was taken to extend the definition of risk to missed business opportunities on the basis that an opportunity missed today could become life-threatening in a few years time.

The directors did a count of current initiatives and bright ideas relating to such opportunities and quickly realised that there was an initiative overload which resulted in scarce resource being spread too thinly. Each of these initiatives and ideas was prioritised and the ones which were most closely aligned with the business objectives and which could develop quick payback were identified. A succinct report was ready within two days and discussed at the board meeting. The report was very well received and action points were created for those responsible for the significant risks.

A positive impact on the company took place, not only in terms of improving the management of downside risk, but also in terms of focusing attention successfully on new business opportunities.

With effective planning, the length of a risk management workshop can be reduced. However, whilst the above company had a two hour session, this may not be sufficient for every company.

> Good risk management has the potential to re-orient the whole organisation around performance improvement.

What do you need to do if operational management is initially sceptical?

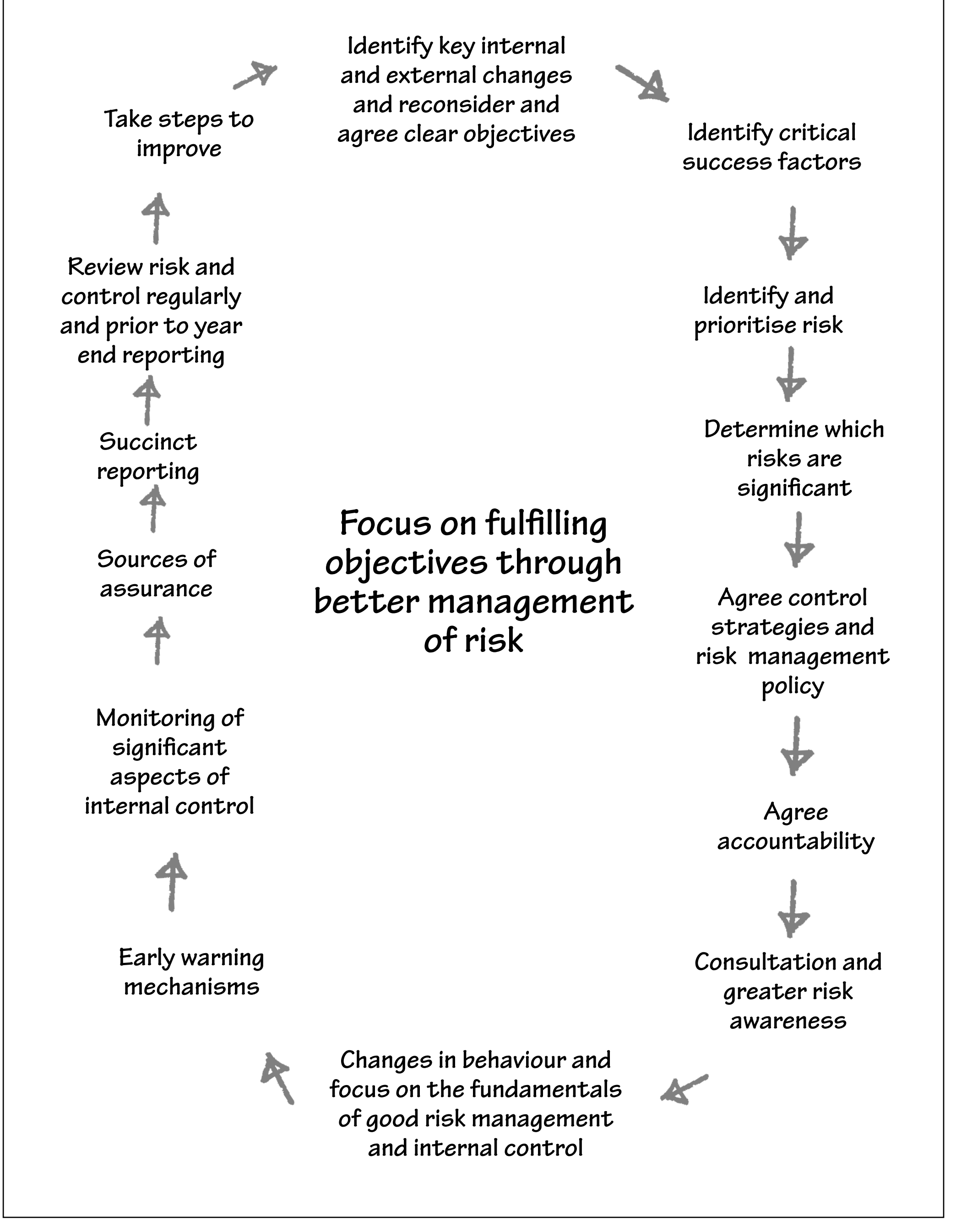
It is particularly useful to focus on:

- not merely risk management and internal control, but putting in place a framework for considering risk and reward which will help facilitate the achievement of the company's main business objectives;
- the introduction of an ongoing process which builds on the existing system and helps the establishment, review, awareness and reinforcement of business objectives, critical success factors, succinct reporting and key performance and risk indicators;
- the increasing level of external and internal change to which companies are subjected. As change increases, so too does the need for risk management.

2.2 What could the process look like?

Set out below in figure 2 is a way of putting Turnbull into effect which you may find to be useful in gaining the buy-in of operational management.

Figure 2 How Turnbull can be put into effect



Treat Turnbull as the opportunity to improve, not only the management of risk, but also the business as a whole.

A board must decide on what it wants to achieve. Without clearly establishing what is wanted from the company, it is difficult, if not impossible, to determine when (and even if) the goals have been met. Objectives such as 'being in the FTSE 350' or 'increasing profits by 10%' are valid, but these are high-level goals. They should be broken down into focused and achievable goals, against which it is easy to determine risks and to gauge when they have been met. For example, a specific objective might be to increase the customer base by 10% by way of superior customer service.

In setting clear company objectives, it is important that they are expressed around the future, and not around the past or the present. The board should ask itself whether the objectives it already has will meet the challenges that it is likely to face over at least the next two or three years.

2.3 What is different to previous approaches?

Concern has been expressed that the 'traditional' approach to risk workshops puts too much emphasis on risk identification and not enough on risk management. If too many risks are identified, then it is very difficult to identify and manage the significant ones.

The Turnbull guidance focuses on significant risks; those risks which have been identified by the senior management as being potentially damaging to the achievement of the company's objectives.

Following the identification of these risks, there should be consultation throughout the company on issues such as:

- **awareness of the company's objectives and related significant risks;**
- **the company's risk management policy;**
- **whether the control strategies adopted are effective and what needs to be done to put them into effect;**
- **the fundamentals of good risk management and internal control;**
- **ways in which improvements can be made in order to mitigate the significant risks affecting the ability of the company to achieve its business objectives;**
- **changing behaviour.**

This consultation can help identify whether senior management has identified all the significant risks relevant to the objectives, particularly having regard to the changing internal and external environment. It also provides the board with a sound foundation for its review of the effectiveness of internal control and for its reporting to shareholders on control.

In summary, the emphasis is on a combination of applying a 'top down' approach, consultation throughout the company and the fundamentals of good risk management and internal control.

What do you do if you have previously identified numerous risks?

Boards need to avoid the situation of 'risk identification overload' as this can prevent the significant risks being given appropriate attention. If lots of risks have been previously identified, they can be usefully analysed on the basis of relevance to meeting the business objectives and to highlighting areas where new objectives may be needed.

> Risk management is essential for reducing the probability that corporate objectives are jeopardised by unforeseen events. All that the company is trying to achieve can be affected by risk exposures. They should be proactively managed.

2.4 Groups and international operations

What happens if a company is the parent company of a group?

Turnbull expects that the review of effectiveness of, and the report to shareholders on, internal control, should be from the perspective of the group as a whole. Therefore, care should be taken to give priority to the management of the risks which are significant to the group as a whole. Care should also be taken to avoid two processes – one 'top down' and one 'bottom up' – being performed independently of each other.

Where there are divisions or subsidiaries, scope exists for their boards to follow up the top down process of the main board with 'middle down processes' which give priority to the risks which are significant to the group but also address the risks which are significant to the governance of the divisions and subsidiaries. This ensures that the main objectives of the group are instilled into all staff as well as each division or subsidiary, focusing on areas which are specific to them.

Where there are joint ventures and associates, there may be practical obstacles to extending the group's risk management and internal control processes to them. In such circumstances, Turnbull expects disclosure where material joint ventures and associates have not been dealt with as part of the group.

Where there are international operations, there will be a need to consider exposure to risk across borders.

Useful questions to ask include:

- **Should we develop a group risk management policy document so that there is more awareness of the main board's attitude to risk management?**
- **Do policies need to be developed on what the main board regards as significant to the group as a whole for the purpose of early warning mechanisms and reporting?**
- **In decentralised groups, is there scope to use Turnbull to reduce the risk of sudden unwelcome surprises? Also, how does management take account of significant risks at both business and group level?**
- **In acquisitive groups, is there scope to use Turnbull to reduce the time taken to realise merger benefits?**
- **What steps need to be taken to improve the co-ordination of monitoring and assurance procedures?**
- **How is the group going to maintain focus on the risks which are significant to the group as a whole?**
- **Is there sufficient documentary evidence of the management of risk across the group?**

3. Immediate actions

3.1 Have you the right attitude to risk management and internal control?

Directors should be alert to the following problems which may undermine decisions relating to Turnbull:

- The board thinks that risk management is 'not their problem'.
- The company is still focused only on internal financial control.
- There is no consensus amongst the board about what are the business objectives.
- Review of internal control is regarded only as a regulatory exercise for the purpose of making a public statement.
- Risk management is seen as the responsibility of one function such as audit or insurance.
- There are no key risk indicators and there is no training in risk awareness for the employees.

Avoid rolling out separately a new 'Turnbull' initiative if you already have a major change initiative relating to improving people's performance. Keep that initiative going, but build in the principles of effective management of risk to the company's objectives. Don't create competing initiatives in this area. Aim to 'piggy-back' on existing ones.

3.2 Avoiding unnecessary complexity and cost

A key issue for smaller listed companies is a potential lack of available resources for risk management and internal control procedures. It is therefore sensible to keep these procedures as simple and straightforward as possible. Also, there is no business sense in maintaining procedures where costs outweigh the benefits to the business. However, it is important to recognise that, with only a few product lines, key people or major assets, the need to preserve what the company has got through sound risk management is very important. Figure 3 over the page sets out some useful principles to bear in mind in order to keep costs down.

Case Study No. 2

Blue plc has been under increasing pressure from its main customers over recent years to improve responsiveness. Contractual terms keep being tightened up. Another problem is that there are a number of business units which carry out diverse business activities. Against a backdrop of increasing pressure on results, there was a need to identify, with more clarity, why the business was not achieving its business objectives.

The managing director, the finance director and another executive director began with a top down approach to risk management including missed business opportunities, and then went on to organise similar risk round table meetings at the main operating units. This was designed to introduce a more motivated approach to managing downside risk and to create a more innovative approach to operational activities.

A key theme underlying the process was to use it to keep the cost base in line with growth. Indeed, 'failure to control the cost base' was identified as a significant risk in respect of which accountable persons, control strategies and improved reporting mechanisms were agreed. The aim was also to sharpen up, rather than add, resources to the control activities. This was done by focusing on reporting by exception directly to senior management, sacrificing some level of detail in the management information for greater timeliness and making staff continually aware of cost control and the need to avoid another significant risk: 'failure to be responsive to customers'.

There has been an improvement both in the financial results and in relations with key customers.

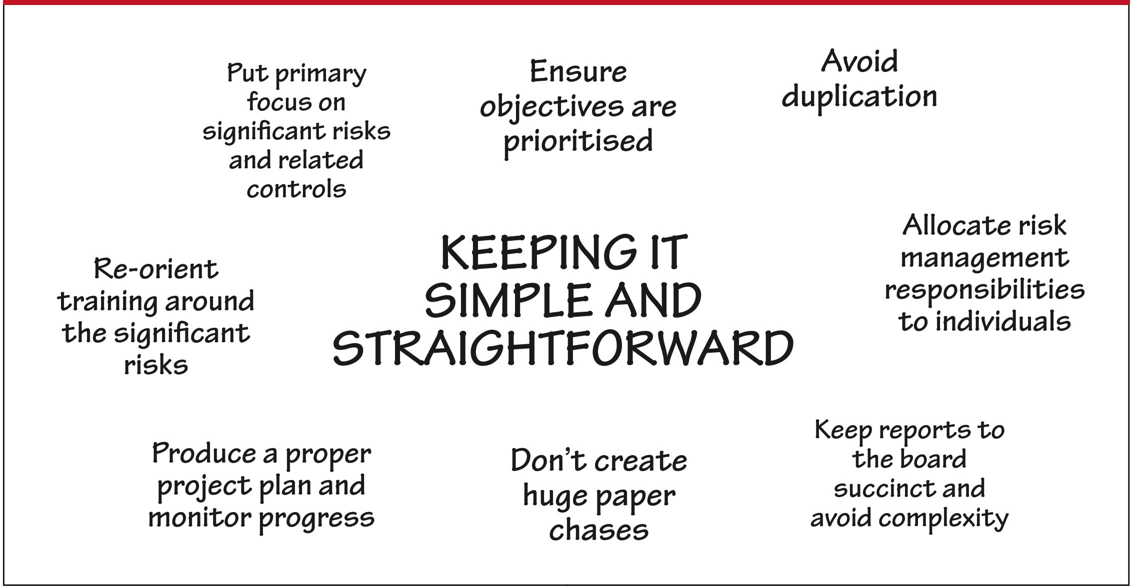


Figure 3 Avoiding unnecessary complexity and cost

3.3 What needs to be done now?

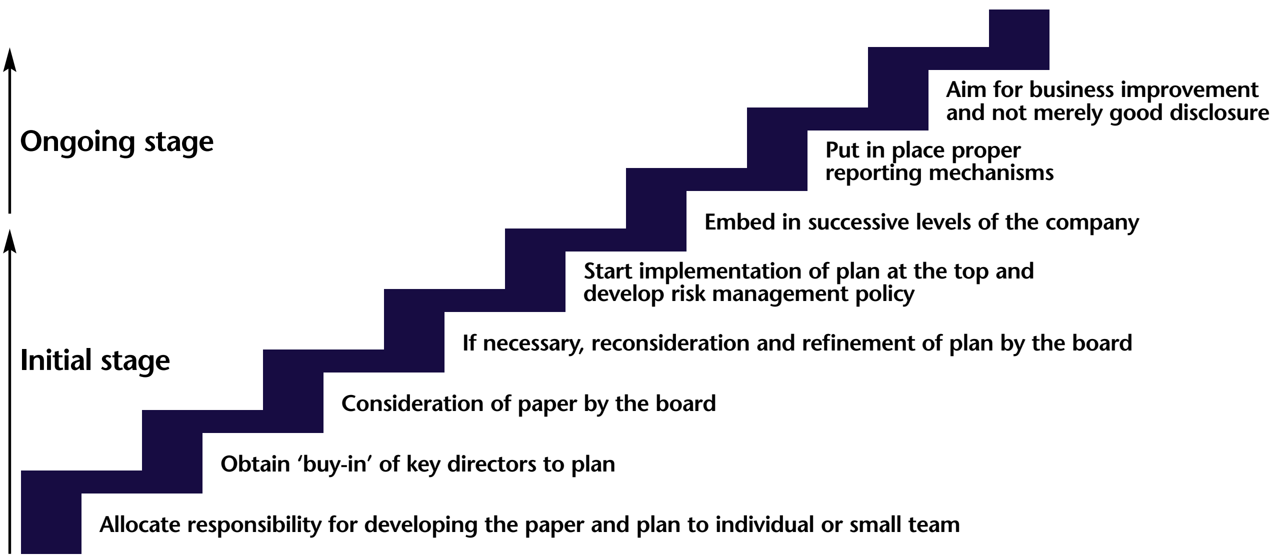
Recognise the importance of getting the buy-in of people at all levels of the company. Whilst at the outset this will involve obtaining the support of senior management and the board, there is also a need to get the 'grass roots' support at the operational level. It is useful to recommend that Turnbull be treated as an operational project with two stages – these being the initial stage and the ongoing stage.

The planning of the project needs to be delegated to a person or persons who can devote the appropriate time to it. Let the delegated person get on with the planning in a co-ordinated manner. Insist on a chart identifying key deliverables, responsibilities and time-scales. It is particularly useful to involve someone with operational experience as many of the significant risks which will require addressing will be operational by nature.

Do not make the plan too complicated as this may alienate some management and staff.

Some suggested steps for the project are set out in figure 4 below.

Figure 4 Suggested steps



The ongoing stage is continuous. Monitoring of risk and control is needed.

There should be fine-tuning of a company's risk management and internal control strategies and policy in response to changing exposures. A feedback process is vital in order to learn from mistakes and to harness potential business improvements and risk reductions.

What are the key elements of the initial paper to put to the board?

The key elements could be as follows:

Figure 5 Contents of paper to the board

The background to Turnbull including:

- Listing Rule 12.43A.
- Combined Code principle D.2. and provisions D.2.1 and D.2.2.
- The publication of the final version of the Turnbull guidance.
- The opportunity to facilitate the achievement of business objectives.

Identification and prioritisation of areas of change, business objectives, critical success factors and risks which may be significant.

Identification of related significant risks which could undermine:

- the reliability of internal and external reporting;
- the safeguarding of assets from inappropriate use, loss and fraud; and
- liabilities being identified and managed properly.

Identification of key tasks to be completed in order to:

- develop risk management strategies and a risk management policy document;
- consult throughout the business;
- improve the culture at all levels of the company;
- provide the senior management and board with early warning mechanisms; and
- monitor the system of internal control.

The role, if any, of board committee(s)

Allocation of:

- resource (as necessary);
- responsibility for each stage of the plan; and
- responsibility for management of each significant risk.

Timetable

It is also useful to prepare a detailed plan to support the paper presented to the board. It ensures that if questions about the paper are asked, sufficient work has been done to answer them as they arise.

The purpose of a risk management policy document is to set out clearly for all employees, the board's attitude to risk and the appetite for risk which it is prepared to accept. It is also an opportunity to demonstrate to all levels of the company that the board takes risk management very seriously.

Useful questions for members of the board to ask include:

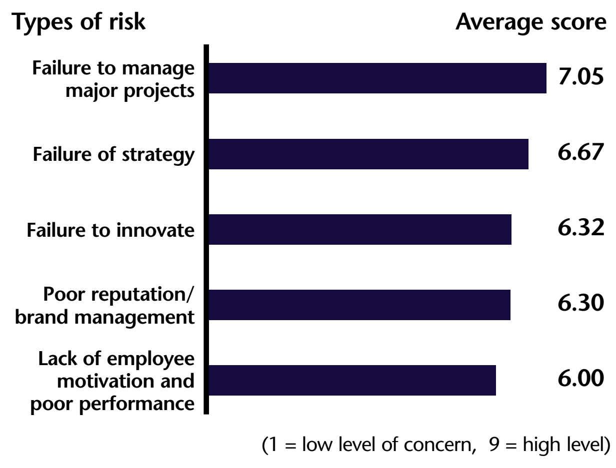
- **How realistic is the plan?**
- **How comfortable are they with the risks being taken in the business?**
- **Are there plans for risk management training for, or discussion with, employees?**
- **What are there by way of early warning mechanisms for identifying potential disasters?**
- **Do they feel comfortable that we could defend a risk decision after a 'shock' or disaster?**
- **Have the more likely kinds of fraud been identified and are there controls in place which could prevent and detect them?**
- **What steps are being taken to ensure that past control failings do not recur?**

4. Risks

4.1 What are the significant types of risks which could be addressed?

A recent survey revealed which types of risk were normally of most concern.

Figure 6 Results of 1999 Deloitte & Touche survey of significant risks



The survey indicated that the most significant risks were frequently operational or strategic in nature. The major projects which were identified frequently had a technology element.

How do you go about identifying risks?

- Understand the business's services and products
- Know the market place
- Consider the business process risks
- Also consider how people might behave in different situations
- Consider the quality of the local management team
- Think about the changing external environment

The matrix in figure 7 over the page, sets out various risks to consider but should not be regarded as comprehensive. There are, of course, various ways of setting out matrices, but it is particularly useful to include items which might immediately trigger a response from the board. Bland risk descriptions should be avoided. In the financial and some other sectors, it will be difficult to categorise between business, financial, operational and compliance risks. Also, some risks can be included under more than one heading.

A pitfall to avoid is merely selecting risks from a generic matrix. The risks need to be specific to the industry sector and the circumstances of the company. It is particularly useful to relate them to the likely obstacles facing the critical success factors which underpin the achievement of the company's objectives. Useful questions to ask include:

- How is change affecting the risks we face and the risks we have chosen to take (this is because change areas are often the biggest areas of risk for a business)?
- What would we hate to see reported in the press?
- What problems or near misses have already happened to us or our competitors in recent years?
- What are the types of fraud and business probity issues to which the business could be particularly susceptible?
- What are the major regulatory and legal risks to which the business is exposed?
- What risks arise from the business processes?

4.2 How much risk could you take and in which areas?

Directors need to consider formally which risks are 'significant'. It is for the board to decide on their significance, according to the nature, extent and timing of events and the amount of 'headroom' available to the company should major problems occur.

> Risk-return relationships and therefore the company's risk exposure are determined, not only by the external business environment, but also by the actions of its managers.

4.3 Should you quantify risks?

The detailed quantification of risk can be useful but in a smaller listed company it is perhaps enough to quantify risk as high, moderate or low. What matters most is that the board and management develop a clear, shared understanding of what risks are unacceptable or likely to become unacceptable, and then decide on how they are going to manage the risks using different control strategies.

Figure 7 Risk matrix

Business
Wrong business strategy
Competitive pressure on price/market share
General economic problems
Regional economic problems
Political risks
Obsolescence of technology
Substitute products
Adverse government policy
Industry sector in decline
Take-over target
Inability to obtain further capital
Bad acquisition
Too slow to innovate

Financial
Liquidity risk
Market risk
Going concern problems
Overtrading
Credit risk
Interest risk
Currency risk
High cost of capital
Treasury risk
Misuse of financial resources
Occurrence of types of fraud to which the business is susceptible
Misstatement risk related to published financial information
Breakdown of accounting system
Unrecorded liabilities
Unreliable accounting records
Penetration and attack of IT systems by hackers
Decisions based on incomplete or faulty information
Too much data and not enough analysis
Unfulfilled promises to investors

Compliance
Breach of Listing Rules
Breach of financial regulations
Breach of Companies Act requirements
Litigation risk
Breach of competition laws
VAT problems
Breach of other regulations and laws
Tax penalties
Health and safety risks
Environmental problems

Operational and other
Business processes not aligned to strategic goals
Failure of major change initiative
Loss of entrepreneurial spirit
Stock-out of raw materials
Skills shortage
Physical disasters (including fire and explosion)
Failure to create and exploit intangible assets
Loss of intangible assets
Breach of confidentiality
Loss of physical assets
Lack of business continuity
Succession problems
Year 2000 problems
Loss of key people
Inability to reduce cost base
Major customers impose tough contract obligations
Over-reliance on key suppliers or customers
Failure of new products or services
Poor service levels
Failure to satisfy customers
Quality problems
Lack of orders
Failure of major project
Loss of key contracts
Inability to make use of the Internet
Failure of outsource provider to deliver
Industrial action
Failure of big technology related project
Lack of employee motivation or efficiency
Inability to implement change
Inefficient/ineffective processing of documents
Poor brand management
Product liability
Inefficient/ineffective management process
Problems arising from exploiting employees in developing countries
Other business probity issues
Other issues giving rise to reputational problems
Missed business opportunities

Case Study No. 3

Green plc introduced control self-assessment techniques for some of its key operating units several years ago. This mainly involved using workshops to identify risks. The results were initially well received by the board but each year its enthusiasm and that of the staff waned a little more. The non-executive directors were concerned that the board was doing nothing to address many of the risks identified.

Turnbull has re-invigorated the workshops. A highly successful workshop has been held by senior operational management with the emphasis on avoiding major operational disasters and on identifying and responding to the potential obstacles to achieving the critical success factors for the next three years. The risks previously identified in the staff workshops were reviewed so that senior management were aware of the key issues highlighted in the past. Precise quantification of risk was avoided as it was felt that it would complicate and slow down the process.

An ongoing programme is being arranged for the staff but much more emphasis is being placed on:

- **awareness of the company's business objectives;**
- **risk awareness and the fundamentals of good risk management and internal control;**
- **the alignment of business objectives, risks and control;**
- **the identification and maintenance of early warning mechanisms;**
- **quicker responsiveness to changes within the company and to the external environment; and**
- **the sharing of good practices for improving the business.**

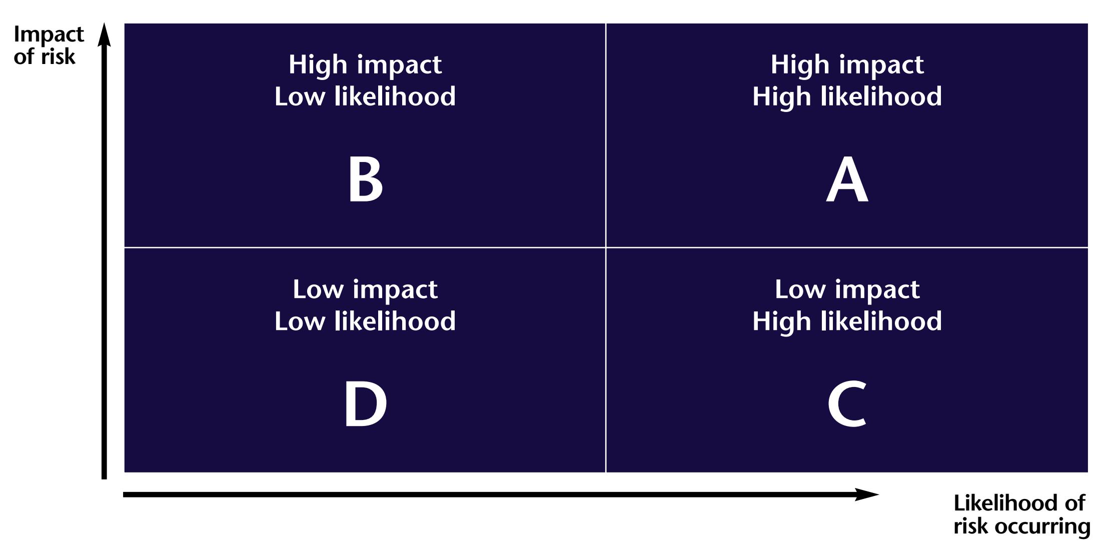
The general feeling is that the new workshop programme will be much more relevant to the needs of the business.

4.4 Prioritisation of risks

How could risks be prioritised?

The following 'two by two' diagram in figure 8 is widely used. First you need to assess the gross risk associated with an event, that is the probability and impact of the event on the assumption that control processes are very weak or non-existent.

Figure 8 How to prioritise risks



As can be seen, risks are prioritised according to their impact and likelihood. Generally an A,B,C or D rating will suffice, which can be interpreted as:

A Immediate action
B Consider action and have a contingency plan
C Consider action
D Keep under periodic review

The impact should be considered not merely in financial terms, but more importantly in terms of potential effect on the achievement of the company's objectives. Not all risks will be identified as significant. Non-significant risks would be reviewed regularly, particularly in the light of changing external events, to check that they remain non-significant.

Some boards prefer to use a 'three by three' alternative which offers more analysis than a simple 'two by two'. Some companies go as far as using a 'six by six'.

What do you do after the gross risks have been prioritised?

Having identified and then prioritised the significant risks in gross terms, it is then helpful to determine for each of these, (1) do the directors wish to accept this risk, (2) what is the control strategy to avoid or mitigate the gross risk, (3) who is accountable for managing the risk and maintaining and monitoring the controls, (4) what is the residual risk, that is the risk remaining after the application of the control processes, and (5) what is the early warning mechanism?

Taking each of these points in turn:

1. Each gross risk is considered in the context of the company's objectives. The board decides whether the identified risks exceed the benefits which will be obtained by achieving the objectives i.e., is it worthwhile to continue with a particular objective if the risks outweigh the reward? If the decision is to carry on, the board must decide how to respond to the risk by adopting specific control strategies.

**The board need to determine their risk appetite i.e. the amount of risk which they are willing to take.
This involves considering, for significant risks, whether the risk/reward ratio is appropriate.**

2. Control strategies include:
- accepting the risk;
- transferring the risk (e.g. passing it to another party by changing contractual terms);
- elimination (by adopting an exit strategy);
- control (by building control into the operational process, additional quality control, involving your best people in managing it);
- sharing the risk with another party;
- insuring against some or all of the risk;
- avoiding the risk in other ways.

3. Delegation of responsibility for managing risk in totality would not be allocated to a single individual. Ideally, it would be spread across those responsible for managing different business activities.

4. Consideration could be given to determining the level of risk remaining after the application of the control strategy. A key point to note is that it is not possible to eliminate risk entirely. Risk management policies need to be aligned with the company's objectives – there is no use in trying to eliminate all risks in the company, since some risk will always be undertaken in order to make profit. You need to know your risk profile and how to manage it. Where there are risks, they need to be sensible risks and not reckless or ill-considered ones. The company's business objectives need to be appropriate to the risk appetite of the board.

The number of risks identified as significant should preferably be limited. As a rough guide, a company could face as few as fifteen to twenty-five residual risks which require group management attention and which are significant to the group as a whole.

5. Early warning mechanisms are reporting processes which enable the board and senior management to be alerted **before** a problem becomes a disaster, and at a stage when action can be taken to mitigate or overcome the situation. The idea behind 'Key Risk Indicators' (as a form of early warning mechanism) is to give early indication of potential problems in order that corrective action may be taken promptly.

> Business objectives and related plans need to include measurable performance targets and indicators. 'Key Performance Indicators' can be very useful early warning mechanisms. However, management's usual 'Key Performance Indicators' may not be sufficient on their own for this purpose as they are generally designed to report past results. By the time the Key Performance Indicators have shown a significant deterioration it may be too late to prevent losses or other adverse effects. Therefore, consider also the use of 'Key Risk Indicators'.

Case Study No. 4

Purple plc's sales and other figures looked good but the monthly management information gave no indication to the board that there had been a significant level of change in the sales force in the key regions. As a result, the sudden slump in sales took the directors totally by surprise and also precipitated a severe cash flow crisis.

Therefore, in determining their early warning mechanisms, Purple plc's management introduced people turnover into their reports from operating units as one of their key risk indicators.

Key questions which could be asked in this area include:

- **Does the current management information provided to the board and senior management give them sufficient early warning of potential problems?**
- **Is there awareness of trigger events, or frequency of events, for each significant business risk which should alert management to a potentially significant issue?**
- **Does potential board news travel quick enough to the top of the company and is action taken quickly enough?**

It should be borne in mind that under the Combined Code on Corporate Governance, the company chairman has a specific responsibility to ensure that all directors are properly briefed on issues arising at board meetings.

5. Embedding the process

> By changing behaviour at all levels of the company and embedding better business practices within day-to-day activities, there is less need for a multitude of control procedures to be laid on top of the business.

After performing the high-level steps described above, should the process of introducing Turnbull be 'embedded'?

The answer is emphatically yes, as the Turnbull guidance expects the system of internal control to be embedded in the operations and form part of the culture. Also, the guidance expects risk management and internal control to be ongoing, and it is difficult, perhaps impossible, to achieve this unless the process is deepened. The key to achieving this is consultation throughout the business.

Useful steps you can take in this area include:

- **a memo from the Managing Director to all members of management and staff to 'kick off' the deepening of risk management and internal control;**
- **dissemination of a risk management policy document and codes of conduct;**
- **'round tables' and workshops at different levels of the company on risk management and internal control;**
- **re-allocation of some of the training budget to specific business risk training;**
- **dissemination of the key business objectives and significant risks;**
- **clear communication of policy on how significant risks are to be managed;**
- **involvement of staff in identifying and responding to change and in operating early warning mechanisms; and**
- **channels of communication for people to report suspected breaches or other improprieties.**

Turnbull suggests that policies may be communicated on such things as customer relations, service levels for both internal and outsourced activities, health, safety and environmental protection, security of tangible and intangible assets including business continuity, expenditure, and accounting and financial and other reporting.

The aim should be to improve the culture at all levels of the company so that management and staff become more focused on meeting company objectives and managing properly the significant risks.

People issues which need to be considered include:

- **whether the remuneration policies and working practices encourage good risk management and actually discourage taking reckless or bad risks;**
- **how to instill an attitude of 'doing things right first time';**
- **whether accountability for fulfilling business objectives and managing related risk is sufficiently clear;**
- **how to create an environment in which people are willing to report problems rather than to 'sit on them';**
- **whether the actions of different parts of the company are appropriately co-ordinated;**
- **whether the people in the company and in outsource providers have sufficient knowledge, skills and tools to support the achievement of the company's objectives and to manage the significant risks effectively;**
- **how to introduce a common risk management vocabulary across the company; and**
- **the adoption of work practices and training which result in improved performance.**

Employee understanding of the purpose of controls and a sense of 'ownership' are critical to success.

Turnbull says that all employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, need to 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.

A major point which Turnbull stresses is that control should be embedded within the business processes by which a company pursues its objectives. It follows that, rather than developing separate risk reporting systems, it is best to build early warning mechanisms into existing management information systems. Cumbersome risk management databases can be a distraction from the key point which is that each person in the organisation becomes more focused on meeting the business objectives and in managing significant risks which relate to the tasks which he or she performs.

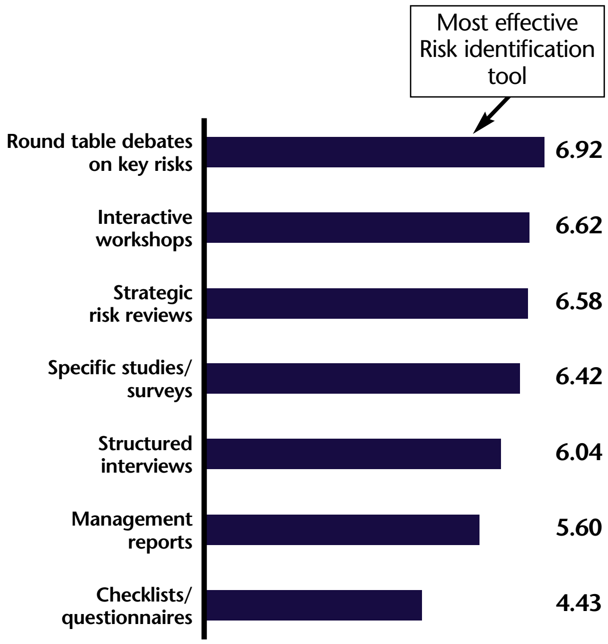
A key issue which can be addressed is the extent to which executive committees put significant risk management issues on their agenda. Where there is a risk committee, it should avoid usurping the role of the executive committee. It can encourage and foster good risk management and awareness, but it should not take over the role of the executive management.

Opportunities exist through embedding risk management to remove duplicate or unnecessary controls and to create an environment where, subject to sound risk management practices, there is more empowerment for people within the company to work to satisfy the needs of customers.

Senior management and the board need to ask whether they have enough timely, relevant and reliable reports on progress against business objectives and the significant risks. For instance, do they have enough qualitative information on customer satisfaction and employee attitudes? Also, as risks change, do they have the necessary business information to respond effectively?

You cannot rely only on an initial workshop. Changing external factors and internal problems result in new or significantly changing risks arising. There is a need to find out whether the employees believe that risk management is really mitigating significant risk. Unless other steps are taken, the board or senior management can be blissfully unaware of an impending disaster until it is too late. Set out in figure 9 opposite, are the results of a recent survey indicating which are the better techniques for identifying risk.

Figure 9 Deloitte & Touche 1999 survey of useful techniques for identifying business risk



(1= low effectiveness, 9= high effectiveness)

Case Study No. 5

Red plc had a 'bottleneck' in that most key decisions had to go through a central department which, although it contained talented people, was overloaded with work. This overload had the effect of slowing down the responsiveness of the company and the danger of problems arising from the situation was perceived, by senior management, as a risk to the business.

The department head took decisive action as part of a risk management initiative. This involved a departmental round table discussion on business objectives and risks, a 'change initiative' and follow up.

The initiative has been a success. The bottleneck has been removed, the department is much more highly regarded and the risk has been considerably reduced.

Identifying risks, good communication and addressing people issues are, however, not enough. There is also a need to ensure that the fundamentals of good risk management and internal control are maintained.

A high level of management and employee involvement in improving risk management and internal control is usually needed in order to turn around a problem unit or department.

What are the fundamentals of good risk management and internal control?
These are illustrated in figure 10 below.

Figure 10 Fundamentals of good risk management and internal control

Emphasis on changing behaviour

Keeping it simple

Risk awareness

Fundamental controls e.g. financial controls

Reliable business information

GOOD RISK MANAGEMENT AND INTERNAL CONTROL

Consultation throughout the company

Early warning Mechanisms and quick response

Awareness of business objectives

Continual application of control strategies

Management should ensure that in designing risk management and internal control procedures, they do not limit opportunities for innovation, emerging good practices and potential company benefits. However, it is useful to set out the scope for the freedom within which people are allowed to act.

What about internal financial control?
Internal financial control remains vitally important and is needed to provide the board and senior management with information of sufficient quality to make good decisions. Key areas to consider include the need for:

- good accounting records;
- regular reconciliations;
- clearance of suspense accounts and review of unusual items;
- 'true and fair' year end reporting and reliable interim reporting;
- combating the risk of fraud;
- the safeguarding of assets from inappropriate use or loss;
- the avoidance of losses from derivatives and financial instruments;
- reliable management information from within and outside the company; and
- liabilities to be identified and managed.

Internal financial control is a key part of the fundamentals of good risk management which should underpin the wider aspects of business risk.

Frequently, many fundamentals of good risk management and internal control are already in place. Do not replace what is already working well.

Key questions which directors of smaller listed companies could ask in this area are:

- Does the workforce have sufficient understanding of the business objectives and risks relevant to the tasks which they perform?
- How can the speed of reporting of potential problems be improved?
- Are key financial, operational and compliance controls, e.g. reconciliations, sufficiently up to date?
- Are there any areas of the business which could give rise to public embarrassment, and, if so, how can they be improved?

Case Study No. 6

Black plc is a manufacturer. The company has turnover of £55 million and three manufacturing locations. Due to its size, management did not believe a full time internal audit function was necessary. The company has a small number of customers and has been losing market share as competitors move manufacturing facilities overseas to take advantage of lower production costs. Management decided to commence a risk identification and awareness programme with senior and middle management. The programme was managed by external advisers to remove internal bias and provide resource to drive through the exercise.

The major concern of management at the start of the programme was how to ensure that the project added value to the organisation. They were anxious that the project should not be seen as purely form filling or compliant in nature. Therefore, it was split into three phases.

Phase One – an initial meeting with the board, including non-executives, to clarify the company's strategy and identify strategic risks;

Phase Two – time spent one-on-one with middle management to explore operational, financial and IT risks and business opportunities;

Phase Three – testing of key procedures including stock ordering and usage, stock recording and preparation of management information.

Results

The board discussion generated significant debate concerning the company's strategy. This led to clarification of the strategy and presentation of this strategy to employees. The discussion formalised approaches to a number of risks. None of the risks in isolation were new to the company, but a formal approach to managing them had not been previously developed. Two specific examples being the creation of a role to explore sourcing and manufacturing opportunities overseas and formal reporting to the board of key customer relationships including the involvement of the marketing department to assess them.

Phase Two identified a number of new operational risks including a lack of appropriate non-financial management information, such as the reporting of waste levels, inflexible pay rates not matching workloads and supplier unreliability leading to production disruptions.

Phase Three has become an ongoing process with periodic checks on key financial and non-financial systems and procedures, with results being presented to, and well received by, the board.

6. Monitoring and Internal Audit

What can an internal audit function contribute?
The board and senior management need to satisfy themselves that their systems of risk management and internal control are working properly. Line management has the primary responsibility for providing assurance to senior management and the board on the company's risk management and internal control framework. The board may decide to seek an objective view, that is independent of line management. An internal audit function, with the right level of resources, should be able to:

a) provide objective assurance to the board and management as to the adequacy and effectiveness of the company's risk management and internal control framework;

b) assist management to improve the processes by which risks are identified and managed; and

c) assist the board with its responsibilities to strengthen and improve the risk management and internal control framework.

Internal audit can also make a significant and valuable contribution to the company by:
- providing advice on the management of risk, especially those issues surrounding the design, implementation and operation of systems of internal control;
- enhancing efficient and effective risk and control management by identifying opportunities to save on costs of control and/or the avoidance of operational and similar losses;
- promoting risk and control concepts within the company e.g. by running or facilitating control self-assessment programmes.

Is it worthwhile introducing an internal audit function?
The answer will depend on the company's circumstances. If no internal audit function exists, the Turnbull guidance interprets the Combined Code's requirement to review the need for one 'from time to time' as an annual requirement. The board, therefore, needs to consider annually the business case for internal audit, carefully reviewing the business benefits against likely costs.

The benefits of an internal audit function include:

- **being a valuable source of advice to all parts of the company on good risk identification, risk management and internal control procedures;**
- **receipt of objective assurance from monitoring activities for many parts of the company; and**
- **assistance for the board in developing the material to support their review of the effectiveness of internal control.**

If resources do not permit a full in-house function, an alternative is to outsource partially or fully internal audit activities.

If there already is an internal audit function, will it need to be repositioned?
Senior management and the board need to consider the value added to the company by the function and benchmark it against best practice to determine whether any change is needed.

Indicators for change include:

- **old fashioned view that internal auditors are regarded as 'policemen';**
- **an outdated approach of telling management what to do, rather than a modern business partnership approach;**
- **internal audit not taken into the confidence of management; and**
- **unqualified staff with low business awareness and poor management and interpersonal skills.**

It is essential to move away from internal audit having its own 'universe of risks' and telling management and staff what the risks are. Internal audit can usefully work with operational management and staff in identifying risks, in helping to ensure that the assessment of risks by management is objective and in encouraging effective risk management processes and internal control.

What do you do if you have insufficient resources for an internal audit function?

Turnbull puts the emphasis on the need to design processes which monitor the continuing effectiveness of the way the company manages risk. This will apply even where there is no internal audit function.

Some boards, particularly of small companies, may decide not to have an internal audit function. In such circumstances, the directors could find it useful to ask themselves the following questions:

- Can we improve the quality of the information which is regularly passed to the board?
- Can we agree with the external auditors that they will do particular work on the higher risk areas?
- Can we invite the individuals in charge of key departments or operating units to attend part of a board meeting on a more regular basis, to account for, and answer questions on, the running of their part of the business and the managing of its risks?
- Can we change the regular agenda of the board, or of the executive committee, so that there is more focus on risk and control on an ongoing basis?
- Can more use be made of confirmations from key employees of compliance with the company's policies and codes of conduct?
- Can we do more to make sure that Turnbull is not treated as a 'one off' initiative? For example, by the directors consulting more with the workforce about whether the control strategies are succeeding and whether risks to the business objectives are being dealt with adequately.
- Can the directors take more of a role in monitoring on a 'peer review basis'?

Turnbull says that, in the absence of an internal audit function, the board will need to assess whether other monitoring processes provide sufficient and objective assurance.

Case Study No. 7

Yellow plc is a small listed company in a very competitive sector. The directors formed the view that there is insufficient resource for an internal audit function. They also believe that the six board directors are sufficiently close to the business to know what is going on. A non- executive director was appointed who wants more assurance that the risks are being managed properly on an ongoing basis.

With the help of their external advisers, the directors held a risk management workshop which identified significant risks and the related control strategies. An issue which emerged was that the company had expanded in recent years in two countries overseas and into a new business area with which the directors had less day-to-day involvement. It was agreed that:

- **one of the directors would increase his visits to the new international operations;**
- **another director would become responsible for monitoring the new business area;**
- **management information would be more focused towards succinct key risk indicators;**
- **the board calendar and agenda would be strengthened to put more focus on risk management and internal control;**
- **directors would have more meetings with employees during the year on risk and control issues; and**
- **the board would appoint two further non-executive directors to comply with the Combined Code.**

The external auditors were asked to perform some special work on the growing treasury activities, to provide more benchmarking analysis and to focus more on testing controls in certain higher risk areas. The non-executive director was directly involved in the discussion with them about the scope of the work which they will perform.

The directors agreed that it made sense, not only from a Turnbull perspective, but also because it was sound business practice, to review the need, in a year's time, for the creation of an in-house internal audit function or the use of an outsourcing provider of internal audit services or a mixture of both.

7. Board level considerations

7.1 When could the board consider risk management and internal control?

A board calendar, focusing only on risk management and internal control, is set out in figure 11 below. It assumes a December year end and phased implementation arrangements rather than full early compliance.

Figure 11 Board calendar for risk management and internal control

Board calendar

October 1999	If not done already, consideration of the initial paper to put to the board and in particular: – the key tasks to be completed; – the allocation of resource; – the timetable.
December 1999	Consider progress of the Turnbull plan and, in particular, whether: – all the questions set out in the appendix to the Turnbull guidance are being addressed; – the wording of the risk management policy document is appropriate and there are arrangements for its dissemination; – an internal audit function is needed (if it does not exist already) and if not, does the board receive sufficient and objective assurance from management; – all disclosure points are being properly addressed.
February 2000	Consideration of work undertaken on risk and control. Identification of possible significant problems and initial consideration of internal control disclosures in light of implementation arrangements.
March 2000	Consideration of final wording of disclosure for the annual report and supporting documentation for related board review of effectiveness of internal financial control.
May 2000	Consideration of steps to improve risk management and internal control further and to review objectives and key risks (updating as necessary). Re-allocation of resource to most significant risks and problem departments.
October 2000	Further review of progress with regard to risk management and internal control procedures including the annual review of the need for internal audit.
February 2001	Consideration of annual assessment (see the section of Turnbull on the process for reviewing effectiveness). Identification of possible significant control failings or weaknesses and initial consideration of internal control disclosures in light of full disclosure requirements.
March 2001	Meeting to consider final wording of full disclosure in December 2000 annual report and supporting documentation for related board review of effectiveness.

Turnbull indicates that, besides the annual assessment, the board should regularly receive and review reports on internal control.

Key risk indicators and the results of embedded monitoring should be supplied to the board or designated committee(s) on an ongoing basis and the chairman of the board could encourage discussion of risk management and internal control issues at each board meeting. Reports from other committees, such as the executive and audit committees, also provide opportunities to discuss risk and control.

An addition to a normal board agenda for each meeting during the year might be 'risk and control issues'. Useful questions for directors to ask at regular meetings include:

- Given the size of (specified) project, what key risk indicators are being put in place to give us early warning if it is not succeeding?
- Is a full risk analysis being performed as part of the due diligence of an acquisition?
- Has a risk analysis been performed as part of a strategic exercise and, if so, how are we managing the risk?
- How are controls operating in (specified area) to meet the significant risks identified?
- Are there any problems disclosed in the annual report and accounts which have material internal control aspects?
- What risk management and internal control procedures are we carrying out to prevent (describe an event reported in the press about a competitor) affecting us?

Boards of small companies may wish to discuss risk management and internal control more frequently given that they generally meet more often and have a more 'hands-on' approach to the running of the company, and have less management personnel to deal with the issues.

7.2 Where can the board find assurance?

Possible sources of assurance on risk management and internal control for smaller listed companies are set out over the page.

The cost/benefit considerations will be important in determining the extent to which 'independent monitoring activities' are used, particularly by smaller companies.

The main source of assurance will be from line management. Internal audit, health and safety, and environmental monitoring teams fall within 'independent monitoring activities' and are normally good forms of objective assurance and advice if a company has these functions. Boards could also use the useful techniques for identifying business risk (given previously in figure 9) to obtain the required assurance, e.g. the board may gather the views of employees in facilitated workshops using CSA techniques (Control Self-Assessment), structured interviews or round table discussions.

Directors will find it useful when performing their annual assessment to have a paper which sets out the significant risks originally identified, any new risks, whether the controls are operating satisfactorily and an indication of the sources of assurance which they are taking account of.

Figure 12 Sources of assurance

The level of effectiveness of these sources depends, amongst other factors, on the:

- extent to which the process is ongoing
- speed of communication to the board
- ability to manage the residual risk.
- focus on key business objectives
- timeliness of identification of risk

7.3 What does the board need to consider in reviewing reports?

Turnbull says that reports from management to the board should, in relation to the areas covered by them, provide a balanced assessment of the system of 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. Useful issues to be considered include whether:

- the reports are indicative of new significant risks;
- risks previously identified are still acceptable;
- the control strategies need to be changed;
- amendments need to be made to procedures;
- additional monitoring of the system is needed;
- the risk management policy document needs to be updated;
- the response time to change needs improving;
- the communication channels throughout the company are effective, or amendments need to be made.

Frequency of assessment

The reports should be made to the board on a regular basis in order for the board to ensure that it has an up-to-date picture of the company's current control situation. It is effectively a process of continuous assessment which needs to ensure that all significant aspects of the business have been addressed.

> When significant control failings or weaknesses arise, the responsible manager should be asked to attend the meeting of the board or the designated committee at which the issue is discussed

8. Disclosures

An example of a group disclosure for the first accounting period ending on or after 23 December 1999 is set out in figure 13 below. It is not intended to be a standard wording and should be tailored to the circumstances of the company.

Figure 13 Specimen statement: smaller plc

SPECIMEN STATEMENT ON INTERNAL CONTROL FOR A SMALLER PLC

(for the first accounting period ending on or after 23 December 1999)

Internal Control

The group has adopted the transitional approach for the Combined Code set out in the letter from the London Stock Exchange to listed companies at the end of September 1999 and reports as follows:

Wider aspects of internal control

The board confirms that it has established the procedures necessary to implement the guidance *Internal Control: Guidance for Directors on the Combined Code*[1].

Or:

The board expects to have the procedures in place in May 2000 necessary to implement the guidance *Internal Control: Guidance for Directors on the Combined Code.* This takes account of the time needed to put in place the procedures which the board has agreed should be established. These include holding a risk management workshop, attended by all board members, together with prioritising change issues, the group's objectives and risks and determining a control strategy for each of the significant risks. A risk management policy document is also being sent to all employees setting out the board's attitude to risks to the achievement of the business objectives. The monthly management information is also being improved with the addition of some key risk indicators.[2]

The board has considered the need for internal audit, but has decided that because of the size of the group it cannot be justified at present. The board will review this decision next year.[3]

The board has changed its meeting calendar and agenda so that risk management and internal control will be considered on a regular basis during the year and there will be a full risk and control assessment before reporting on the year ending 31 December 2000.[4]

Internal financial control

The board is responsible for the group's system of internal financial control and for reviewing its effectiveness. Such a system can only provide reasonable and not absolute assurance against material misstatement or loss.

Key procedures are as follows:
The board considers, on a monthly basis, the comparison between budgeted and actual financial performance. The managing director reviews all applications for expenditure over £X and the finance director reviews the payroll which is outsourced for reasons of cost control. Each director is responsible to the board for the financial performance of his or her part of the business. During the year the external auditors performed a special review of the procurement system and this area of control has been strengthened.

The board has conducted a review of the effectiveness of the system of internal financial control for the year ended 31 December 1999, and has taken account of material developments which have taken place since the year end. The review was performed on the basis of the criteria set out in the Guidance for Directors 'Internal Control and Financial Reporting' issued in December 1994.[5,6]

[1]This paragraph assumes that the group has satisfied the Exchange's implementation arrangements for the first accounting period ending on or after 23 December 1999, by putting in place procedures necessary to comply fully with the guidance for the next accounting period.

[2]Alternatively, this paragraph assumes that the group is still putting in place its procedures under the Exchange's implementation arrangements. When a company has not been able to put in place the procedures necessary to implement the guidance, it should indicate the date by which it will have done so. The discussion on what it proposes to do is additional voluntary disclosure. The explanation is intended to provide meaningful, high-level information which does not give a misleading impression. **([1] and [2] are alternatives.)**

[3]This disclosure is not required but may be useful in indicating a situation where there is currently no internal audit function. However a group would be required to disclose if it did not have an internal audit function and had not reviewed the need for one.

[4]This disclosure is not required but the board may decide that it is useful to refer to the review process for reporting on the next year.

[5]The Rutteman internal financial control disclosures are required on the basis that the group is not yet in full compliance with the Turnbull guidance.

[6]It should be borne in mind that the statement on internal control will be subject to review by the external auditor and that Turnbull expects that the board will be provided with sound, appropriately documented, support for that statement.

9. Other considerations

9.1 Board committees

The board is responsible for the company's system of internal control. It needs to set appropriate policies on internal control and seek regular assurance on whether the system is functioning effectively. A major change to the final version of Turnbull is that it is clear that management is responsible for implementing the policies adopted by the board. There is, however, reference to board committee(s). These committees (be they audit, risk, executive or other) could regularly receive and review reports on internal control relevant to their terms of reference.

Useful questions which they can ask include:

- Has a plan been developed for coping with Turnbull and is the timetable achievable?
- Who has been made responsible for developing and rolling out the Turnbull plan?
- Has senior management identified for each significant risk who is accountable, the control strategy, the early warning mechanism and the residual risk?
- How is the company embedding its risk management and internal control processes?
- What specific steps are being taken in the areas of fraud, environmental, treasury and IT related risks?
- In what area is there work still to be done to meet the recommendations of the Turnbull Working Party's guidance?
- Will the company be in a position to report in accordance with London Stock Exchange requirements?
- Are there material internal control aspects of any significant problems disclosed in the annual report and accounts?

Be careful to avoid audit committee overload. It is not the responsibility of the audit committee to identify and manage risks. This is the responsibility of management.

The extent of involvement of the audit committee, as a designated committee of the board, is for the board itself to decide. The Combined Code indicates that all companies, irrespective of size, should have an audit committee. Given the available time, the audit committee may be limited to high-level challenge of the steps being taken to comply with the Turnbull guidance. Boards may wish to confine the role of the audit committee to internal financial control.

Some companies, especially larger listed companies and financial institutions, may wish to set up a risk committee to foster good risk management and internal control. However, other companies will wish to embed risk management and internal control review as much as possible within the executive committee. This would, of course, warrant an internal review of whether the agenda and management information could be improved from a risk management and internal control perspective.

9.2 Benchmarking performance

How far do we need to go in order to be at the leading edge?

Hopefully, once companies have established the basic embedded procedures and monitoring activities required by the Turnbull guidance, they will seek to improve continuously their systems.

The diagram in figure 14 opposite, provides outline guidance to assist smaller listed companies in assessing their position with regard to the Turnbull procedures against other companies and the procedures which could be established. There are lots of other good ideas which are suitable for those who want to go further. However, the aim should be to do this on a cost/benefit basis.

9.3 Pitfalls to avoid

Turnbull needs to be implemented as smoothly as possible. The important areas where a company could fall down in are illustrated in figure 15 opposite.

What matters most is not putting in place unnecessary bureaucracy, but improving, where necessary, the risk management awareness of the people who perform the basic tasks on which the business depends. There is also a need to focus on the speed of communication of risk along existing channels and on the promptness and appropriateness of the response. For many organisations this may involve making better use of their existing procedures and enhancing existing software and reporting systems.

In order to gauge whether you are doing enough, it is often useful to send someone on industry sector risk management courses and to develop contacts with personnel in risk management or assessment in similar companies to your own.

Figure 14 Levels for benchmarking purposes

Minimal

- Minimalistic disclosure
- Loose linkage to business objectives
- Limited discussion by board
- Turnbull viewed mainly as compliance exercise
- Board review just sufficient to comply with Turnbull
- Monitoring heavily dependent on directors themselves
- Little employee involvement

Moderate

- Link to what drives the business
- Reasonable involvement of employees
- Risk awareness training
- Positive acceptance of internal audit
- Buy-in obtained from different levels of management
- Some use of workshop techniques
- Application of the fundamentals of good risk management and internal control
- Simple and straightforward early warning mechanisms

Leading Edge

- Awareness of business objectives throughout the company
- Focus risk management to 'acceptable' level
- Internal audit function is source of advice on aspects of risk and control
- Other independent monitoring activities
- Turnbull used as business improver
- Risk management and internal control is part of the vocabulary throughout the business
- Consultation throughout the company

Figure 15 Potential pitfalls

POTENTIAL PITFALLS

- No early warning mechanism
- Insufficient focus on the fundamentals of good risk management
- Not addressing high risks properly
- Too many identified risks
- Inability to get 'buy-in' of operational management
- Leaving it too late
- Adding bureaucracy
- Ignoring basic internal financial control
- Audit committee overload

10. Conclusion

What effect could Turnbull have on your company?

Once you have been through the processes described above, you should not declare victory. Turnbull is not intended to be a 'one-off' initiative. You should use the processes to help the business continuously improve. This should have the following consequences:

- **The company's objectives are more likely to be met;**
- **Significant risks are known and monitored;**
- **Less 'surprises';**
- **Improved forward planning;**
- **The business has improved; and**
- **Fewer sleepless nights for directors and shareholders.**

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