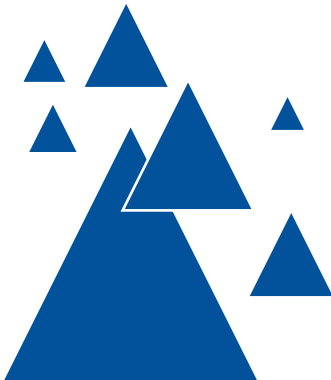


THE
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CHARTERED
ACCOUNTANTS
OF SCOTLAND



Reporting on Internal Control in the UK and the US: Insights from the Turnbull and Sarbanes-Oxley Consultations

Researchers: Laura F Spira Catherine Gowthorpe



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by

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OREWORD

The changes that were brought about to internal control reporting by the Sarbanes-Oxley Act and the Turnbull guidance provide a real opportunity to look at the implications of these requirements and the process of policy development. This report reviews two different approaches to internal control reporting in the US and UK, both in terms of definition and regulatory approach, before contrasting the responses of respondents to the Sarbanes-Oxley section 404 consultation and the Turnbull review consultation in 2004/5. These contrasting views provide a novel insight into the role of consultation in regulatory change in two important regimes. Indeed, the report recommends that there should be more transparency in the process of policy development with policy makers demonstrating how responses have influenced deliberations.

Despite the perception of an 'Anglo-American' approach to corporate governance, there are distinct differences in approach to internal control reporting in the UK and US. The US takes a legislative approach compared to the UK's voluntary codes based on the principle of 'comply or explain'. The definition of internal control in the UK is wider and more closely aligned to risk management procedures. External auditors have more responsibilities for internal control reporting in the US. Such disclosure is aimed at improving accountability but how do these disclosure requirements impact upon behaviour? The researchers' examination of views expressed about disclosure regulation provides a useful insight into this.

The report highlights significant issues for further research including: the impact of internal control reporting on organisations and audit committees; the implications for international convergence of different definitions of internal control; a cost comparison between a principles-based and a rules-based system for internal control disclosure; and the impact of disclosure requirements on the risk appetite of boards.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the project will provide some insight into the developments in internal control reporting and the role of consultations in policy development.

David Spence
Convener, Research Committee
August 2008

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E XECUTIVE SUMMARY

A changing regulatory environment and evolving approaches to corporate governance issues have made disclosure an important regulatory tool. Internal control is recognised as a key corporate governance mechanism and disclosure of information about internal control systems is viewed as a significant component in the process of restoring public trust in corporate probity in the wake of financial scandal. Reporting by boards of directors on the internal control systems within their companies has become an important part of corporate governance disclosure requirements in both the US and the UK.

This study explores the background to the increasing demands for disclosures on internal control by corporate boards and the different responses to these demands in the UK and the US. The objective of the study is to seek an improved understanding of the rationale for these increasing demands and the responses of disclosers and their audiences to the impact of the disclosure requirements which have been established in the two countries.

In the wake of scandals which raised widespread concerns about the control of corporate activities, public consultation has become a regular feature of the process of regulatory change in corporate governance and financial reporting. Responses have been invited to proposals made by both government legislators and non-governmental bodies. Such consultation processes legitimise the adoption of the proposals: although the bodies concerned do not always indicate precisely how the responses have fed into their deliberations, or how they may have influenced the final outcome, technological developments make it possible for these responses to be made publicly accessible at the click of a computer mouse

so that interested parties may, in theory, make their own judgements about this. This study focuses on the responses to two consultations which took place during 2004/5.

In 2002 the United States government introduced the Public Company Accounting Reform and Investor Protection Act, generally known as the Sarbanes-Oxley Act (SOX) after the Senator and Representative who sponsored it. Section 404 of the Act contains the main provisions relating to internal control. The implementation of the legislation required the Securities and Exchange Commission (SEC) to introduce a series of rules and the first proposed rule dealing with section 404 was issued in October 2002. In April 2005 the SEC hosted a Round Table to discuss the experience of implementing section 404 and also invited public comment. This set of comments, received between February and November 2005, is analysed in this study.

In contrast to the legislative approach adopted in the United States, the United Kingdom has chosen to establish corporate governance requirements based around voluntary codes, following a principle of 'comply or explain' and building on the initial recommendations of the Cadbury Committee in 1992 to develop the framework of the Combined Code. Issues relating to internal control disclosure were addressed in detail by the Turnbull guidance for directors published in 1999 but following the events in the United States, which had highlighted the importance of internal control, the Financial Reporting Council instituted a review of this guidance in 2005. To assist in conducting its work, the review group invited public comment on a list of seventeen questions (see appendix C). The consultation period ran from December 2004 until March 2005.

This study compares and contrasts the responses to these two consultations, grounding this analysis in the different approaches to the issue in the UK and the US. The study's analysis of the responses received to the public consultations in each country is set against the backdrop of the historical development of concerns about internal

control and its disclosure. As this demonstrates, the story of internal control is still unfolding. The scope of internal control continues to be defined in varying ways. These definitions and their interpretation in practice are influenced by the perspectives of those involved in devising, operating, managing and evaluating control systems, as well as regulators and policy-makers who view internal control as part of the architecture of organisational accountability. This study provides a snapshot of some of these different perspectives.

The main issues identified by respondents are: costs incurred by disclosers; the role of regulation; changing relationships with auditors; the impact on audiences for disclosure; and links between internal control and risk management. Respondents proposed a range of recommendations for change.

A striking contrast is noted between the UK and the US in connection with the importance of the relationship between internal control and risk management. The most important perceived difference is that the US is narrowly focused on internal financial controls, in contrast to the UK where the interpretation of internal control is broader and more closely linked to risk management. This reflects the history of concerns relating to internal control under the two different regulatory regimes. The need for a clear definition of the boundaries of auditor responsibilities with regard to investigating and reporting on corporate internal control systems became apparent at an earlier date in the more litigious US environment.

The study also identifies different emphases on the costs of compliance with disclosure requirements under each regime. US respondents expressed the view that compliance with the Sarbanes Oxley legislation demanded significant and costly investigation and adjustment to internal control systems; compliance cost appeared to be far less important to UK respondents and some considered that the disclosure requirements had had a positive effect by raising awareness at board level of the importance of risk management. This contrast

suggests that internal control disclosure requirements which focus narrowly on regulatory compliance could inhibit the achievement of business objectives, a concern expressed in the UK at the time of the introduction of the Cadbury Code and further emphasised by the Hampel Committee's subsequent review. An alternative holistic approach which recognises both the strategic and operational aspects of internal control has the potential to add value, as recognised by respondents to the UK Turnbull consultation.

Neither group of respondents had much to say about the impact on audit committees which, given the emphasis on the role of audit committees as a corporate governance oversight mechanism in both countries, is perhaps surprising and raises a further question as to what extent increased internal control disclosure requirements have affected the audit committee role.

UK responses display a fundamental concern with retaining a 'principles-based' approach, viewed as a defence against the imposition of legislation by regulators which is generally believed to have negative effects. However, the interpretation of the difference between 'rules-based' and 'principles-based' systems with regard to internal control reporting is not clear. This lack of clarity may have significant consequences for progress towards international standardisation of frameworks for financial reporting and corporate governance. If definitions and interpretations vary between countries often viewed as having a common approach, what are the implications for international convergence?

The formats of the consultation responses differed. Those responding to the Turnbull review were directed to answer a set of specific questions whereas the SOX respondents were not limited in this way. Awareness of this contextual difference during the analysis of the data highlighted similarities and contrasts in the style and tone of the responses which were found to be conjectural, emotional, or evidence-based in nature. This classification prompted reflections on the role of public consultation in regulatory development. Although consultation responses are often

published, it is not clear how they have been taken into account by regulators in the process of framing new or changed policy. Do responses couched in emotional language or those which are largely conjectural carry equal weight with those providing a broader range of apparently objective evidence in support of arguments expressed?

The contrasts identified in this study raise a number of questions about the impact of disclosure requirements which should be of concern to regulators and policy makers. Where disclosure is aimed at promoting accountability through behavioural norms, as in the UK, rather than through legislative compliance as in the US, what effect does this have within organisations? The varying level of concern about compliance costs suggests the possibility that these different approaches may differ in terms of regulatory cost impact. To what extent do varying disclosure requirements influence the risk appetite of corporate boards?

Disclosure requirements are designed to make the hidden visible, based on the assumption that this will promote trust. However, regulations are embedded in national, historical and cultural contexts. Even where broad similarity is evident, underlying differences with regard to definition and interpretation of concepts, like internal control, may be significant. Adoption of regulatory solutions that have been developed in different environments may be ineffective if such differences are not fully recognised. Successful harmonisation of regulatory approaches will also demand a sound understanding of these differences.

1 INTRODUCTION

Disclosure of corporate information satisfies several requirements. It enables shareholders to hold management to account; it also provides a broader range of stakeholders with the basis for decisions that they may wish to make about their relationships with companies. More recently, disclosure has become a regulatory mechanism. As perceived corporate governance failures led to increasing demands for regulation, policy makers were faced with the challenge of identifying mechanisms that satisfied the objective of ensuring corporate accountability without introducing a burden of legislative compliance that might negatively affect entrepreneurial activity. Disclosure of information proved to be an appropriate solution.

Information disclosure is assumed to provide a basis for corporate control through the discipline of the market as investors react to the information. The anticipation of a negative market response following disclosure may also affect corporate behaviour, as Cary (1967) observed:

Disclosure is the most realistic means of coping with the ever-present problem of conflicts of interest. In some instances our conduct is motivated by what we think is right, without regard to anything else. But, perhaps equally important, ethical behaviour - and wise counselling - results from estimating the public reaction to a full knowledge of a planned course of conduct. The requirement of disclosure in certain instances, and its possibility always, is thus a most important regulatory force in our society. Disclosure is the foundation of reliance on self-regulatory approaches to conflict problems and is the clearest alternative to greater governmental or institutional intervention. (p.408)

Reference is frequently made to the 'Anglo-American' approach to corporate governance, in contrast to frameworks of corporate structure and regulation elsewhere in the world. However, the regulatory environments of the UK and the US differ quite significantly. This study focuses on a specific topic of corporate disclosure - internal control - sited in the contrasting disclosure regimes of the US and the UK. In the US, securities legislation has relied on mandated disclosure since the 1930s and the US corporate governance regime has followed this pattern. In the UK corporate governance policy has been based around the development of voluntary codes and the principle of 'comply or explain'. Under this system, disclosure of information about compliance becomes effectively mandatory, although compliance with the actual codes is not. Bush (2005) provides an analysis of the differences in financial reporting resulting from these different approaches. Other comparative descriptions can be found in Charkham (2005) and Benston *et al.* (2006).

In spite of this fundamental difference in regulatory approach between the two countries, improved internal control disclosure is viewed as an important factor in restoring trust in financial reporting in both countries. This study explores the contrasting routes taken by legislators and policy-makers to arrive at this similar conclusion. The study aims to provide an improved understanding of the rationale underlying the disclosure requirements and their impact on those involved in preparing, evaluating and using the disclosures.

Current internal control disclosure requirements are to be found in the US in the Sarbanes-Oxley Act of 2002(SOX). Section 404 of SOX and subsequent rules adopted by the Securities and Exchange Commission (SEC) require companies that file annual reports with the Commission to report on management's responsibilities to establish and maintain adequate internal control over the company's financial reporting process, as well as management's assessment of the effectiveness of those internal controls. Section 404 and the auditing standards of the Public Company Accounting Oversight Board (PCAOB) require

the accounting firm that audits the company's financial statements to report on management's assessment, as well as on the effectiveness of the company's controls.

In the UK, internal control disclosure rules form part of the Combined Code. The Turnbull guidance issued in 1999 provides details of best practice on internal control and assistance in applying the relevant section of the Combined Code. Brief summaries of the disclosure requirements in both countries are set out in appendix A and B.

Public consultations were conducted during 2004/5 on the impact of both section 404 of the Sarbanes-Oxley Act and on the Turnbull Committee's guidance for directors on reporting on internal control. As part of an ongoing programme of rule development and review, the SEC invited comment on early experiences with implementation of section 404. In July 2004 the UK Financial Reporting Council set up a group to review the Turnbull guidance and update it where necessary, in the light of experience in implementing the guidance and developments in the UK and internationally since 1999. Both sets of consultation responses are publicly available and form the basis of this study.

Chapter two sets out the context of the study in more detail, drawing on relevant literature to describe the development of internal control disclosure requirements to provide a background to the analysis which follows. Chapter three describes the research methods used. Chapter four discusses the findings drawn from the responses to the SOX section 404 consultation and chapter five discusses the findings with regard to the responses to the consultation on the Turnbull guidance. In chapter six the findings from the previous two chapters are compared and contrasted to draw out the implications of the analysis. Chapter seven sets out conclusions from the findings and offers suggestions for further research.

2 CONTEXT OF STUDY

Introduction

This chapter outlines the context of the study, explains why internal disclosures are of particular interest with reference to the relevant literature and demonstrates how this study is intended to contribute to this literature. In the first section the general issue of corporate disclosure is briefly sketched; the second section focuses on the history of internal control disclosure and outlines the contrasting disclosure regimes of the UK and the US; the final section summarises the existing research that addresses internal control disclosure.

The role of disclosure

Disclosure of information to stakeholders underpins the processes of ensuring corporate accountability. Legislative protection for investors and creditors is predicated on prescribed disclosure but the nature and credibility of such disclosure is the focus of continuing debate, often stimulated by financial scandals which typically lead to calls for increased or improved disclosure. The assumption is that disclosure will provide stakeholders with information through which they may hold company management to account for the use of resources provided – traditionally known as a stewardship approach.

Developments in the standardisation of financial reporting have been based on a broader rationale, that of decision usefulness, which argues that users of corporate reports need information in order to make a wide range of economic decisions about their relationships with corporations. Current debate on this may be found on the IASB web site - www.iasb.org. Disclosure may also be viewed as an explicit tool of regulation: for example, the Winter Report of 2002 stated:

Disclosure requirements can sometimes provide a more efficient regulatory tool than substantive regulation through more or less detailed rules. Such disclosure creates a lighter regulatory environment and allows for greater flexibility and adaptability. (Winter, p.34)

Research into aspects of corporate disclosure has been extensive and issues have been approached from a variety of disciplinary perspectives. A substantial empirical literature in market-based accounting research has explored the determinants and consequences of corporate disclosure, summarised in Healy and Palepu (2001). Corporate disclosure issues have also been examined by legal scholars (for example, Fox, 1999) and political scientists (for example, Fung *et al.*, 2002).

Most studies are based on a model of disclosure which assumes that information disclosed affects investor behaviour and market perceptions which, in turn, affect management behaviour. However, the knowledge that disclosure will be required may have an earlier and similarly important effect on management behaviour as that of the feedback from the market response and external perceptions. Early commentators on disclosure issues recognised this. Justice Brandeis observed in 1914:

Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. (Brandeis, 1914)

William L Cary, former chairman of the Securities and Exchange Commission wrote in 1967 that:

In some instances our conduct is motivated by what we think is right, without regard to anything else. But, perhaps equally important, ethical behaviour - and wise counselling - results from estimating the public reaction to a full knowledge of a planned

course of conduct. The requirement of disclosure in certain instances, and its possibility always, is thus a most important regulatory force in our society. (Cary, 1967, p.408)

Few studies of disclosure have considered this impact of disclosure requirements on corporate practice. These effects are difficult to assess, although Gibbins *et al.* (1990) develop a model of influences on the corporate disclosure decision and Holland (2006) provides a very rich picture of the financial information communication process.

This study complements these approaches by considering the response of disclosers and their audiences to imposed disclosure requirements, through an analysis of responses submitted to regulators during public consultations on those requirements.

Internal control disclosure: contrasting disclosure regimes

Internal control systems were for many years considered an issue for individual companies and their auditors alone but, as Power observes:

...the subject of internal control, once a guaranteed remedy for sleeplessness, has made a spectacular entry onto political and regulatory agendas. (Power, 1997, p.57)

Three related factors have influenced this change: a changing approach to regulation; the search for appropriate corporate governance mechanisms; and the need for companies to demonstrate the effectiveness of such mechanisms.

Regulators and legislators have focused on internal control issues as a policy response to crises (Cunningham, 2004). Power (1997) analyses the audit 'explosion' in the UK and identifies the development of a regulatory approach which reaches into the 'regulatory space' within

organisations and relies on making internal mechanisms visible and auditable. UK corporate governance requirements rely on corporate disclosure on the principle of 'comply or explain' and are structured in the form of codes of practice, rather than prescriptive legislation. The conformance/compliance responsibility of the board of directors is emphasised and focuses on systems of internal control, of which the board forms a part.

Internal control systems were originally conceived as structural features that supported the achievement of organisational goals. More recently, internal control has been viewed from a more actively preventive aspect, designed to minimise possible obstructions to such achievement. This subtle but important change, reflected in the close identification of internal control with risk management (Spira and Page, 2003), leads to a greater emphasis on the effectiveness of such systems. Providing descriptions of structural mechanisms such as internal control processes may offer boards of directors a means of demonstrating 'good' corporate governance. What was once considered an unremarkable feature of corporate organisation has become an important matter for external disclosure, to demonstrate regulatory compliance.

The US regime

A need to establish the boundaries of external auditor responsibility led to the first concerns about internal control in both the US and the UK. Heier *et al.* (2005) describe the evolution of internal control in the US, emphasising the way in which internal control has been an important focus of reaction to perceived failures of corporate reporting and governance.

They provide a historical account of the problems of defining internal control, tracing its evolution in the context of the history of US auditing practice. The rapid growth of large companies after World War 2 led to the development of more detailed auditing principles and a need to clarify the scope of internal control. The first formal definition came from the American Institute of Accountants in 1948:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. (AIA, 1948, quoted in Heier et al., 2005, p.48)

The breadth of this definition caused some concern to auditors who feared increasing litigation. A new definition issued in 1958 distinguished between ‘accounting control’ (safeguarding assets and checking reliability and accuracy of accounting data) and ‘administrative control’ (promotion of operational efficiency and encouragement of adherence to prescribed management policies) and limited auditors’ responsibility to the review of accounting controls only. This distinction was unclear in practice and led to a significant narrowing of audit focus.

In 1977 the Foreign and Corrupt Practices Act (FCPA) was passed in the US in response to bribery scandals and introduced the notion of the use of internal control as regulation. One commentator observed that:

Internal control is the means seized upon by the government to put a stop to some irregular practices that it doesn't approve of. (Mautz, 1980)

The Act was drafted using the very narrow definition of internal control developed within the auditing profession and gave this a new name: ‘internal accounting control’. Heier et al. (2005) report contemporary comment which suggests that, while the distinction between accounting and administrative controls remained in force formally, in practice it was irrelevant. Indeed, the next development in the internal control saga seems to have ignored this distinction completely.

In 1987, following further financial scandals, the US Treadway Commission on Fraudulent Financial Reporting was set up. The Commission’s report made a series of recommendations for the detection

and prevention of fraud, including a review of the varying concepts of internal control. The Committee of Sponsoring Organizations (COSO) produced an integrated framework for internal control in 1992, based on the following broad definition:

A process...designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations.*
- *Reliability of financial reporting.*
- *Compliance with applicable laws and regulations*

(COSO, 1992, p.9).

The US Sarbanes-Oxley legislation of 2002 was again a response to financial scandals and introduced yet another narrow definition: 'internal control over financial reporting'. The reasons for this are discussed in the SEC Final Rule on Management's Reports on Internal Control over Financial Reporting issued in August 2003 (<http://www.sec.gov/rules/final/33-8238.htm>). The situation was further complicated by apparently divergent references to internal control in sections 302 and 404 of the Act, resolved by a further SEC Rule (13a-15) which distinguished 'disclosure controls and procedures' from 'internal control over financial reporting' (Langevoort, 2006, p.955).

This evolution of the definition of internal control in the US is summarised in Table 2.1.

Table 2.1 Evolution of definition of internal control in the United States

Year	Body/Act	Definition or change	Impact
1948	American Institute of Accountants	'Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.'	Broad
1958	American Institute of Accountants	Distinguished between 'accounting control' (safeguarding assets and checking reliability and accuracy of accounting data) and 'administration control' (promotion of operational efficiency and encouragement of adherence to prescribed management policies).	Narrower, renaming
1977	The Foreign and Corrupt Practices Act (FCPA)	Drafted using narrow definition of internal control as above with new name, 'internal accounting control'.	Narrow and renamed
1987	Treadway Commission	Recommended review of the varying concepts of internal control	
1992	The Committee of Sponsoring Organisations (COSO)	'A process...designed to provide reasonable assurance regarding the achievement of objectives in the following categories: <ul style="list-style-type: none"> • Effectiveness and efficiency of operations. • Reliability of financial reporting. • Compliance with applicable laws and regulations.' 	Broad
2002	The Sarbanes-Oxley Act (SOX)	'internal control over financial reporting'	Narrowed and renamed

Internal control remains an elusive concept, difficult to define appropriately. The broad COSO definition, relevant to a management perspective, sits somewhat uneasily next to the narrower Sarbanes-Oxley definition, drawn from an audit focus. Internal control issues, which began with the concerns of the accountancy profession about the boundaries of auditor responsibility, are now central to the debate about corporate governance and board behaviour.

Heier *et al.* (2005) comment:

*Though the impact of the Sarbanes-Oxley Act on audit procedures and internal control development will be studied for many years, it can also be seen as simply one of many developments in the evolution of internal control definitions, applications or procedures over the twentieth century. Like the Sarbanes-Oxley law, in many cases the changes were reactions to an event in the business environment that identified a weakness in the current view of internal control or its application by either private or public entities. As the SOX itself shows, this evolution of the internal control process, as seen through the many laws, regulations and pronouncements of the twentieth century, has been, in the main, a reactive one, with few proactive steps taken to deal with corporate reporting problems resulting from inadequate controls. (Heier *et al.*, 2005, p.63)*

This reactive position is, in part, the result of the political context in which regulation is developed. This is demonstrated by Shapiro and Matson (2008), who map the US history of internal control reporting, illustrating how powerful interest groups have been able to resist proposals for disclosure.

The UK Regime

In the UK, internal control remained a private matter for companies and their auditors for considerably longer than in the US, but entered into the corporate governance arena with the 1992 report of the Cadbury Committee on the financial aspects of corporate governance. This too was a response to financial scandals and drew on the recommendations of the Treadway Commission, especially with regard to the role of audit committees. Existing legislation implicitly required directors to maintain a system of internal control but the Committee believed that directors' responsibilities needed clarification. Their solution was a recommendation that directors should report on the effectiveness of internal control systems and auditors should report on that statement. The development of criteria for assessing effectiveness and the other practical issues surrounding this controversial recommendation was delegated to the accountancy profession.

The first attempt at this was made by the Rutteman Working Party in 1994 which defined internal control in the same way as the US definition of 1958:

The internal controls established in order to provide reasonable assurance of: a) the safeguarding of assets against unauthorised use or disposition; and b) the maintenance of proper accounting records and the reliability of financial information used within the business or for publication. (Rutteman, 1994, p.1)

Rutteman also reduced the force of the Cadbury recommendation that directors **should** report on the effectiveness of internal controls by replacing this with the suggestion that they might **wish** to do so. The 1998 Hampel report stepped back even further, recognising the problems associated with determining effectiveness and suggesting that auditors should report on internal controls privately to the board. They did

however extend the scope of the definition of internal control and for the first time associated it with risk management.

The link to risk management was developed further in the guidance for directors reporting on internal control issued by the Turnbull Committee in 1999. The guidance adopts a broad definition of internal control and links it closely to risk management, treating the two concepts as almost synonymous, although the relationship remains ambiguous. For example, the COSO framework identified risk assessment as one of the five components of internal control, whereas Turnbull stated that:

A company's system of internal control has a key role in the management of risks that are significant to the fulfillment of its business objectives. (Internal Control Working Party, 1999, p.4)

Table 2.2 summarises these developments in the UK.

Table 2.2 Internal control disclosure developments in the UK

Year	Body	Development
1992	Cadbury Committee	Recommended that directors should report on the effectiveness of internal control systems and auditors should report on that statement.
1994	Rutteman Working Party	Attempted to develop criteria for assessing internal control effectiveness: internal control definition based on US 1958 version. Proposed that directors might wish to report on the effectiveness of internal controls, replacing Cadbury recommendation that they should do so.
1998	Hampel Committee	Noted problem of assessing effectiveness; suggested that auditors should report on internal controls privately to the board. Extended scope of definition of internal control and associated it with risk management for the first time.
1999	Turnbull Committee	Adopted a broad definition of internal control, linked closely to risk management.

As can be seen from this brief review of the evolution of internal control issues in both the US and the UK, varying events and the distinctive political and regulatory environments in each country have given rise to different approaches to the problems revealed. This makes a comparative approach to the investigation of perspectives on internal control disclosures of particular interest.

Disclosure regimes of the US and the UK

Many discussions of corporate governance, particularly those addressing issues of convergence of corporate governance practice on a global scale, refer to the 'Anglo-American model'. Institutional similarities make it convenient to treat US and UK corporate governance in this way in contrast to other models, such as that prevailing in continental Europe and Japan.

Cheffins (2001) notes the similarities:

A distinctive feature of the British corporate governance system is that it strongly resembles its counterpart in the United States. For instance, both countries have well-developed equity markets, with most major business enterprises being quoted on a stock exchange. Also, they share an 'outsider/arm's-length' system of ownership and control. (p.88)

There has been, however, relatively little attention paid to the differences between the US and the UK models. Some descriptive commentary highlights these differences (Charkham, 2005; Dallas, 2004) and they have also been addressed from a historical perspective (Cheffins, 2001; Toms and Wright, 2005). Armour *et al.* (2003, p.532) argue that, unlike the US, in the UK 'The shareholder value model is less deeply rooted than is generally supposed.' Williams and Conley (2004) develop this further, suggesting that there has been a shift in legal

developments that indicates a divergence between the two countries as the corporate social responsibility movement has driven the corporate governance debate away from focus on shareholder wealth to incorporate a broader stakeholder perspective, a movement that has been stronger in the UK than the US. Turnbull (2005) examines the influence of auditing differences. A developing practical interest in the impact of differences between the two regimes is evidenced by the recent initiative of the Institute of Chartered Accountants in England and Wales entitled 'Beyond the Myth of Anglo-American Corporate Governance' (see <http://www.icaew.co.uk/index.cfm?route=122337>). This study aims to contribute to this debate by presenting empirical evidence of differences in approach in the area of reporting on internal control.

Research into internal control disclosure

There is an extensive professional literature which offers advice on practical aspects of internal control and its disclosure which has grown even more significantly in the wake of the Sarbanes-Oxley requirements and consequent demands for advice on compliance. However, there is little indication that this advice is informed by research. Indeed, there has been little empirical research which specifically considers internal control disclosure, although it is addressed tangentially in papers such as Krishnan (2005).

In the UK a study by Mills (1997) surveyed practice in the UK by collecting data in 1994-5 from a survey of the top 100 companies by market capitalisation on the London Stock Exchange (LSE). He concluded that operational controls as well as financial controls formed part of the definition of internal control used in practice, that assessment of internal control effectiveness was considered controversial, that perceptions of effectiveness varied and that risk management systems were closely associated with internal controls in practice.

Abraham *et al.* (2005) used content analysis methods derived from research into a wide range of disclosures to focus specifically on internal control and risk disclosures. They separately identify business

risk, financial risk and internal controls in their analysis of UK risk reporting. They conclude that while regulation may lead to more extensive disclosure, companies may resort to boilerplate disclosures which achieve regulatory compliance but do not provide better quality disclosure.

Spira and Page (2003) offered a broader consideration of the development of internal control issues within the UK corporate governance debate and explored the realignment of internal control with risk management, considering the impact on the internal audit function. They developed these ideas in a more detailed study of the impact of the Turnbull guidance (Page and Spira, 2004).

Research into internal controls and their disclosure in the US is similarly limited. Root (1998) provides an account of the development of the importance of internal control in the US, offering an analysis and critique of the COSO internal control framework which now forms a widely accepted approach to operationalising internal control systems. This is an approved approach for use under the Sarbanes-Oxley Act and has recently been extended into a framework for Enterprise Risk Management.

Hermanson (2000) surveyed a broad range of users of financial reports, paying some attention to differing definitions of internal control. O'Reilly-Allen and McMullen (2002) explored the impact of internal control reporting on users' perceptions of financial statement reliability in an experimental study, using MBA students as surrogates for a broader range of financial statement users. Both of these studies pre-date the impact of the Sarbanes-Oxley legislation. In the wake of Enron, legal scholars such as Cunningham (2004) have explored internal control issues from a regulatory perspective.

No comparative work appears to have been undertaken, although Vanasco *et al.* (1995) provided an international overview of internal control reporting at that date. Surveying the field internationally, Maijoor (2000) pointed out the problems of research into internal control. A central difficulty is defining the concept, a practical as well

as a conceptual problem, as indicated earlier. Research to date has been conducted in a range of different disciplines, with varying concepts of internal control, and has not benefited from any integration of the range of perspectives. Maijor observed that this research also does not address the main issues of concern to policy makers, including the relationship between internal control and other control mechanisms like external audit and NEDs, the effects of internal control on firm performance and the demand for internal control reporting.

Summary

Disclosure requirements can be expected to influence not only disclosure content and the information disclosure process but also corporate behaviour at a broader level, to the extent that reluctance to disclose information about specific activities may deter corporate management from undertaking them. This area is difficult to explore but some insight can be gained from examining views expressed about disclosure regulation by those subject to it. Responses to public consultations provide useful data in this regard and this study contributes to understanding in this area.

The literature which examines internal control as a specific example of disclosure is very limited. Although there has been some interest in examining the disclosures themselves, little attention has been paid to those directly involved in the process of making or using those disclosures. These views are the focus of this study.

The historical development of internal control has been described in this chapter, to illustrate the continually negotiated nature of the ideas involved and to show how they differ between regulatory regimes. Debate about international differences in corporate governance often refers to the 'Anglo-American' framework but in the context of internal control reporting the two countries differ significantly and this study contributes to a further understanding of the differences and their implications.

3 RESEARCH METHOD

Introduction

The study is based on a qualitative analysis of the comments received by the SEC in the consultation on section 404 of the Sarbanes-Oxley Act and on the comments received by the Turnbull Review Group. To date, much of the empirical evidence on both internal control disclosure and on disclosure from a broader perspective has relied on content analysis of the disclosures themselves (e.g. Abraham *et al.*, 2005) and interviews or surveys of selected groups (e.g. Beattie and Pratt, 2002; Solomon *et al.*, 2000). While recognising the limitations of this self-selected sample, the mining of consultation responses offers an opportunity to access the views of a wide group of interested parties and thus to develop a richer insight into varying perspectives on internal control disclosure. This chapter explains how the study was undertaken.

The data on which the study is based is in the public domain and consists of 89 responses to the first round of consultation on the Turnbull guidance (obtained from the Financial Reporting Council website - www.frc.org.uk and 234 responses to the section 404 consultation (downloaded from the SEC web site - www.sec.gov). The respondents include individual investors, company directors and managers, as well as corporations, institutional investors, professional bodies and other organisations with an interest in internal control disclosure (see Tables 3.1 and 3.2 for analysis). A representative sample was selected from these responses.

Content analysis

The research method adopted by this study is that of latent content analysis. There are, broadly, two methods of content analysis: manifest and latent (Berg, 2004). Manifest content analysis involves ascertaining the frequency with which certain elements (single words or phrases) occur in a given text or set of texts. Inferences can then be drawn by the researcher based upon the frequencies identified. Latent content analysis requires the researcher(s) to identify and understand the underlying meaning of the text. As Berg (2004) describes it:

...manifest content is comparable to the surface structure present in the message, and latent content is the deep structural meaning conveyed by the message. (p.269)

There are advantages and disadvantages to both manifest and latent content analysis; Babbie (1995) suggests that the researcher faces a choice between validity and reliability. Manifest content analysis is more objective and reliable, but it can result in relatively superficial findings and may fail to tease out the deeper meaning of the text's content. Latent content analysis is likely to be less reliable in that the analysis cannot be easily replicated, and is influenced by the researcher's own experience, opinions and background. However, its great advantage is that it increases the likelihood of genuine understanding of the deeper meaning of the text.

The researchers decided to adopt latent, rather than manifest, content analysis for the following principal reasons:

- Manifest content analysis was considered to offer a very limited approach to investigation of the data, especially given the variety of forms of consultation response (see Tables 3.1 and 3.2).
- Latent content analysis, as noted, is likely to be influenced by the researcher's own experience, opinions and background. However,

this can be seen as an advantage: the interpretation of experienced and knowledgeable researchers should provide valuable insights and conclusions.

Data preparation, handling and coding

The data was converted into rich text file format and imported into MAXQDA software. Each researcher read all consultation responses and a sample was selected for detailed analysis (see below). The researchers then commenced detailed analysis of the samples, examining firstly the Sarbanes-Oxley responses, and then the Turnbull responses. Two code lists were gradually developed by each researcher: one for each set of responses. Inter-coder reliability was checked by frequent comparison of code lists and discussion. Once initial coding was completed, the individual researchers' lists were combined, resulting in one combined code list for Sarbanes-Oxley responses, and one for Turnbull responses. The combined lists required a limited amount of editing and then were ready for further discussion and analysis.

The code lists were discussed between the researchers in order to confirm the principal themes that had emerged during coding. One of the researchers then built upon the lists to prepare the analyses that are summarised in chapters four and five.

Sample selection

The samples were deliberately biased to ensure inclusion of those responses that appeared distinctive in terms of quality, interest, coverage, or significance. A substantial proportion of responses were, consequently, rejected. Those rejected included the very brief responses by email or short letter which were characteristic of certain groups, such as individual investors.

Sarbanes-Oxley respondents

Table 3.1 summarises the responses by category of respondent and shows the sample size and significance, expressed by means of the percentage of total pages examined. Many responses, especially from the individuals group, were very short indeed, sometimes no more than a couple of lines sent via e-mail (and indeed, a small number appeared to have little, or nothing, to do with Sarbanes-Oxley). All responses of less than a page were counted as one page for the purposes of this exercise. The number of responses of one page or less was 68.

The approach taken to sampling was open-ended, in that a definitive sample size was not determined in advance. However, following the principles of the latent content analysis methodology, sampling continued until it became clear that the principal code categories were well established. The use of the software package MAXQDA enabled the researchers to identify the point at which coding became repetitious and no new categories were emerging.

Both researchers coded all 26 responses. In order to ensure consistency of approach, the code lists were exchanged and discussed at intervals throughout the coding period. One of the researchers used the file combining facility in MAXQDA, and made minor amendments where necessary for the sake of consistency.

Table 3.1 Sarbanes-Oxley respondents: sampling summary

Classification	Number of respondents in group	Total pages submitted by group	Mean length of response	Number of respondents in sample	Total pages in sample	% of total pages examined
Academics	10	34	3.4	0	0	0
Analysts	2	5	2.5	1	4	80.0
Audit firms	7	74	10.6	3	42	56.8
Consultants	11	76	6.9	2	42	55.3
Corporates	119	393	3.3	9	44	11.2
Employees	6	9	1.5	0	0	0
Individuals	39	67	1.7	1	4	6.0
Institutional investors	2	3	1.5	1	1	33.3
Private investors	4	5	1.3	0	0	0
Professional bodies	4	66	16.5	2	57	86.4
Regulators	2	10	5	1	5	50.0
Trade/ industry associations	28	207	7.4	6	65	31.4
Totals	234	949	4.1	26	264	27.8

Turnbull respondents

Table 3.2 summarises the responses by category of respondent to the Turnbull review and shows the sample size and significance, expressed by means of the percentage of total pages examined.

Table 3.2 Turnbull respondents: sampling summary

Classification	Number of respondents in group	Total pages submitted by group	Mean length of response	Number of respondents in sample	Total pages in sample	% of total pages examined
Academics	1	4	4	1	4	100
Audit firms	8	61	7.6	2	16	26.2
Consultants	2	13	6.5	2	13	100
Corporates	44	233	5.3	8	53	22.7
Individuals	6	27	4.5	0	0	0
Institutional investors	8	37	4.6	4	23	62.2
Pressure groups/other organisations	5	46	9.2	2	22	47.8
Professional bodies	10	82	8.2	5	58	70.7
Securities market	1	7	7	0	0	0
Trade/industry associations	4	27	6.8	1	12	44.4
Totals	89	537	6.0	25	201	37.4

In some respects the profiles of the respondents in the two consultation exercises are similar. For example, the corporate group in each case accounts for about half of the number of responses and a little over 40% of the total pages submitted. However, the Sarbanes-Oxley respondents include proportionately more individuals and trade and industry associations.

The same approach was taken to the sampling of the Turnbull responses as was taken for the Sarbanes-Oxley responses. However,

the approach to coding was a little different. Both researchers coded two responses, but then split the coding of other responses between them. The reasons for this were twofold: first, experience had already been gained through coding the Sarbanes-Oxley responses, sufficient to show that both researchers took a very similar approach. Second, it became clear from the initial reading of all the responses that there was a greater degree of homogeneity in respect of Turnbull than of the Sarbanes-Oxley responses. This was, at least in part, due to the similarity in structure of most of the letters, which had been suggested by the request for responses which specified 17 questions. Most letters comprised a fairly brief covering note, together with an appendix dealing with the questions in order.

In order to ensure that a common approach to coding was being maintained the researchers compared code lists and notes frequently. Once the coding of the sample was concluded, one of the researchers used the file combining facility in MAXQDA and then made minor amendments for the sake of consistency.

The researchers then used the code lists to identify the principal preoccupations, arguments and opinions presented by the respondents. Common themes and differences between the results of the two consultation exercises became clearer in the course of discussions between the researchers, resulting in the analysis and conclusions set out in the next few chapters of this report.

Summary

This chapter has explained the approach taken by the researchers to analysis of the contents of the two sets of responses to consultation. The next two chapters explain in detail the findings of the analysis in respect of the Sarbanes-Oxley responses (chapter four) and the Turnbull responses (chapter five).

4 FINDINGS: SARBANES-OXLEY SECTION 404 CONSULTATION

Introduction

In this chapter, three aspects of the response to the Sarbanes-Oxley section 404 (SOX section 404) consultation will be examined. The first, and by far the longest, section of the chapter examines and analyses the content of the responses. The second section examines the features that are potentially of concern but which do not figure large in the responses; this section might be described as ‘what they don’t say’. Finally, the chapter briefly considers ‘how they say it’, examining issues of style as well as content, and the extent to which responses are based on hard evidence. The concluding section of the chapter identifies the principal issues that have arisen from the analysis.

Principal themes emerging from the consultation

The codes emerging from the analysis of the data were grouped around headings that emerged in the course of the coding exercise.

SOX section 404: strengths and benefits

Although many responses concentrated upon explaining drawbacks, problems and weaknesses arising from SOX section 404, most respondents acknowledged at least some benefits arising from this part of the legislation. This section examines the strengths and benefits identified, before then proceeding to consider the various problems reported by respondents.

The benefit that was most commonly claimed by respondents was that of boosting investor confidence and public trust in listed companies. Glass Lewis (a consulting firm whose response came from its managing director, Lynn Turner, a former Chief Accountant of the SEC) suggested that better financial reports would result from the legislation, and that there had been far too little discussion about the benefits arising because so much of the debate had centred on the costs borne by companies in order to achieve compliance with SOX section 404. Ernst & Young, and other respondents, pointed out that some of the benefits were hidden, and that they would be realised over time rather than in a single accounting period.

While many corporate respondents had significant criticisms of the legislation and its effects, they often recognised that their businesses had derived some benefit as a result of compliance. For example, the comment of Universal Corporation was quite typical:

Although the ultimate SOX section 404 requirements were neither representative of legislative intent nor justifiable from a cost/benefit perspective, we nevertheless view the work product we have created as an asset to our company.

Other respondents also pointed out that companies that entered the compliance process with a positive attitude were likely to derive greater benefit than those who regarded compliance as an unmitigated burden.

Nevertheless, although many respondents started with an acknowledgement of benefit, it was clear that the principal reason for their participation in the consultation process was to identify and describe problems.

SOX section 404: weaknesses and problems

Cost

Problems relating to the cost of compliance were a significant feature of almost all responses to the consultation, and in most cases cost constituted the single most important source of complaint. All parties were in agreement that the costs of compliance with SOX section 404 in its first year were very much higher than expected, and higher than they had been led to believe by discussion on the subject in Congress. Compliance costs comprised external consultants' fees, additional audit fees and the cost of resources internal to the corporate bodies under scrutiny. Crowe Chizek, an audit firm, explained in their response some of the factors they believed had contributed to the very high costs. These included: the lack of good technical guidance available to companies; poor project management; lack of high level executive ownership of the internal control reporting process (in some companies); late performance of the work because of the late issue of Auditing Standard 2 (AS2); a general lack of internal control documentation in most companies; the existence of many disparate internal control systems in companies because of prior mergers; and the lack of time available, especially at the year end. Many of these issues were identified by other respondents.

Some respondents, although not generally the companies themselves, certainly believed that the very high costs were attributable, at least in part, to years of neglect of internal control systems in companies. Deloitte raised an important point:

Although companies have been required to maintain adequate internal controls since the passage of the Foreign Corrupt Practices Act in 1977, prior to Sarbanes-Oxley there was no requirement for most companies to regularly assess or report on those controls or for auditors to report on controls.

Ernst & Young referred to the ‘years of deferred maintenance, or even neglect’ experienced by some companies who were now having to make significant efforts and investment to overcome the deficiency. Glass Lewis pointed out the ‘tremendous level of costs’ that they believed had been imposed on investors over the years because of cost cutting and neglect of internal control.

Almost all the corporate respondents were prepared to say that the SOX section 404 compliance efforts had yielded benefits, although many of them questioned the balance of cost with benefit, feeling that the former far outweighed the latter. Several respondents criticised the levels of testing and documentation of controls by the external auditors, which were felt to be excessively zealous. The Confederation of British Industry (CBI) described the documentation required as ‘unrealistic and costly’, while Deutsche Telekom characterised the burden of documentation as ‘overwhelming’ and the Alamo Group commented that:

The need for documentation seemed excessive and driven more by defensive posturing than the need to improve our business.

The Mortgage Bankers Association (MBA) remarked that ‘any concept of materiality is gone – as everything and anything in practice is deemed to be material’.

Many respondents took the view that, although the level of costs had been very high in the first year of implementation, costs in subsequent years would reduce, and some remarked that benefits were likely to follow costs and so had not, at the time of the consultation, been realised in full. Some, however, took a gloomier view, and did not expect their costs to change appreciably. Several respondents supplied supporting data about the level of resources devoted to SOX section 404 compliance. Alamo Group, for example, reported that its external audit fees had increased by over 60%, Microsoft had spent over \$15 million on external consultants up to the point of responding to the

consultation, and the American Electronic Association (AEA) estimated the total implementation cost in the USA at approximately \$35 billion: 'more than 20 times greater than the SEC estimated in 2003'. Deutsche Telekom reported that its additional financial cost up to the point of responding to the consultation lay within the range described by other large European companies (€30-70 million), but that this estimate did not include employee training costs. Ernst & Young reported that, based on anecdotal evidence, they found that approximately 50% of the additional costs incurred by companies were internal, with about 25% accounted for by extra audit fees, and the remaining 25% by payments to external parties, such as consultants. Although the firm felt that costs in subsequent years would be reduced, nevertheless 'the end result will be a substantial permanent increase in audit fees over historical levels'.

The changing auditor/client relationship

An important, and recurrent, category of comment related to the role of the auditor. Some corporate respondents observed that their relationship with external auditors had been adversely affected by SOX section 404. Auditors, too, commented on the nature of the change in auditor/client relationships. The following principal problems were identified:

- Delay in financial statement completion and audit. An auditor-identified error, under the application of AS2 is automatically assessed as a control deficiency. Deloitte reported that this requirement:

...had ...inhibited management-auditor communication, and has adversely affected the timing of when management is willing to provide the auditor their 'position', which in some cases delayed the year-end audit work by as much as three weeks...

- Diminution in the role of professional judgment in auditing. Pepsico, for example, noted:

A substantial part of the work in complying with SOX section 404 is tied into rigid interpretations by the independent registered public accounting firms of some very rules-based pronouncements. This has had the effect of diminishing the role of professional judgment in the independent registered public accounting firms' determination of control adequacy.

- Less open relationship between auditors and management. Corporate managers reported feeling unable to refer queries about the application of GAAP to their auditors. Ernst & Young appreciated clients' difficulties in this respect as auditor involvement in financial reporting could result in a violation of auditor independence or be taken as an indication of the existence of a material weakness in control, a perception shared by Financial Executives International (FEI). But, as Ernst & Young also pointed out:

... the demand for advice and consultation is not likely to abate given the volume and complexity of new accounting standards and reporting requirements, and causing SEC issuers to not seek out such advice or to turn to firms other than their auditing firm for this type of advice would be detrimental to the quality of financial reporting, inefficient for the user and its stakeholders, and likely be unhealthy for the auditing profession.

As well as the additional cost involved in seeking out the opinion of another public accounting firm, at least one company identified a potentially serious problem if the opinion of the other firm on an accounting issue differed from that of the auditors.

- Problem of defensive auditing. Several respondents, including auditors, commented on this tendency. The MBA identified an:

...atmosphere of 'near paranoia' where auditors generally conclude that more testing and documentation is always better than less, regardless of cost/benefit considerations.

Barbara Hackman Franklin (an individual respondent who was US Secretary of Commerce in the first President Bush's administration, and was formerly chair of the Audit Committee of the Dow Chemical Company, and is currently or was formerly director of 14 public companies), identified the 'context of the times' as the underlying reason for defensive auditing:

After the indictment and demise of Arthur Andersen, I believe the remaining audit firms became fearful for their own survival if they should be caught in a similar scandal.

Ernst & Young elaborated this point:

... the PCAOB (Public Company Accounting Oversight Board) and SEC inspection and enforcement systems aren't the only factors. We would be remiss not to acknowledge the influence of the US litigation system.

However, it is important to recognise that not all aspects of the changing relationship between auditors and their clients are detrimental, and some respondents identified positive aspects. Given the recent history of US business, and, in particular, the demise of Arthur Andersen as a result of the Enron affair, an element of distancing in the auditor/

client relationship might be appropriate. According to the consultants, Glass Lewis:

Auditors are acting in an increasingly independent fashion, as they should. This has resulted in financial management being required in some cases to become more responsible for their obligation and responsibility for the preparation of financial statements.

In a similar vein, Barbara Hackman Franklin said:

Auditors became more cautious and conservative as a result of the Andersen demise and the new regulatory climate. As an audit committee member, I would observe that a bit of conservatism isn't a bad thing.

It was also clear from the responses that the auditor's role in SOX section 404 implementation was likely to be subject to change in the second and subsequent years. A criticism frequently encountered in the responses, and which was accepted by the auditors themselves, was that the audit of internal controls had not been properly integrated with the usual financial audit, thus giving rise to further costs. Some, although not all of the criticisms, could be addressed by a more integrated approach to audit work which would be more likely in subsequent years.

Auditing Standard No 2

The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes-Oxley Act of 2002 in order to oversee public company auditors. One of its roles is to issue Auditing Standards. Auditing Standard No.2 *An Audit of Internal Control over Financial Reporting performed in Conjunction with an Audit of Financial Statements* (AS2) was issued in 2004. Its content and application were critical to

the conduct of auditors in the first year that was affected by SOX section 404, and it figured frequently in the comments of respondents to the consultation.

Problems arose because of the timing of the issuance of the standard and related guidance notes. Ernst & Young described the sequence of events, and the complications that arose in consequence:

...complicating the effort was the need for recalibrating the project and performing rework as the requirements of the SEC and particularly of the PCAOB became known or better understood. Much of the preparation for 404 implementation started in 2003 and was in full swing throughout all of 2004. However, most of the guidance for issuers (and for auditors) came in the form of the requirements of the PCAOB's AS2 which was adopted by the PCAOB in March 2004 and then subject to SEC approval which occurred in June 2004. Additional interpretive guidance was issued by the SEC and PCAOB during the latter half of 2004 (in June, July, October and November) and in January 2005.

The comments of Ernst & Young and others made it clear that substantial additional costs were incurred in the first year because of late publication of the detailed regulation. This could be regarded as a single period problem, but other difficulties identified by respondents are likely to be recurrent and persistent. Many respondents agreed that the threshold for errors that was in practice established by the PCAOB in AS2 was far too low. One respondent suggested that the intention of the PCAOB in writing the standard was probably to allow auditors to exercise judgement, but in practice the standard was not interpreted in that way. The precise nature of the problem was identified by FEI:

...the rules and implementation guidance place an inordinate amount of emphasis on documentation of control performance,

classifying inadequate documentation as at least a deficiency and potentially a significant deficiency. This has caused the audit firms to take the position that in the absence of documentation, controls should be presumed to be ineffective.

Both auditors and corporate management tended to agree that the threshold was too low. Another auditor, Crowe Chizek, commented that:

If AS2 is taken literally, then any matter considered to be a misrepresentation or misapplication, even if clearly immaterial, is considered to be a material weakness.

It cannot be supposed that this interpretation was intended by the PCAOB, but this or similar interpretations appear to have been common.

Another common criticism related to the AS2 requirement that each year's audit should be undertaken afresh, without any capacity to rely upon findings from previous years. The Institute of Internal Auditors (IIA), to take one example from many, pointed out that:

Well-established, mature processes do not become unstable or unpredictable merely because a year-end has passed.

The view was generally held that auditors should be allowed to exercise some judgement in this and in other respects. Some respondents to the consultation went so far as to suggest that AS2 and the related guidance were focused too much on rules and that it would be preferable to take a principles-based approach. Equally, however, several respondents asked for clarifications and further guidance on specific issues. Such additional clarification would add to what is already

a substantial body of regulation. Volume of regulation was not, on the whole, perceived as a problem, although an exception was the CBI whose response compared the Turnbull guidance with SOX and preferred the former for reasons of clarity:

The fact that the Turnbull guidance is relatively short and clearly written means that it is accessible to members of the board, managers, auditors and employees, rather than requiring the assistance in interpretation of lawyers and accountants.

A final point is that AS2 forces companies to concentrate on lower level controls. For example, Westpac identified the importance of focusing on ‘company-level’ as opposed to ‘process-level’ controls, and cited evidence from the credit rating agency, Moody’s, which supported that view. It contended that:

The corporate collapses that led to the enactment of SOX section 404 appear to have been largely a result of ethical lapses, collusion and overall ‘tone at the top’ issues.

A similar point was made by Pepsico, which suggested that the PCAOB should incorporate a greater emphasis on ‘tone at the top’ in order to align its approach with the intention of the underlying legislation.

Special cases: foreign issuers and smaller listed companies

Foreign issuers i.e. those companies listed in the USA but whose primary listing is in another jurisdiction, were permitted a period of one year’s deferral of the requirement to comply with SOX section 404. As Ernst & Young pointed out, this was especially welcome in respect of 2004 because many such companies were facing the challenge of the

transition to IFRS in the run up to adoption of IFRS for listed companies in the European Union in 2005. Furthermore, Ernst & Young suggested that SOX section 404 compliance was likely to present even greater challenges to some foreign issuers:

...[they] face many of the same issues that US public companies have experienced, but often the effects are magnified due to language differences, business environments, regulatory requirements, and other considerations.

In respect of UK companies, the CBI response contrasted the experience of Turnbull and SOX compliance, to the detriment of SOX:

...the vast majority of our members' US costs are perceived to be around documentation issues, rather than dealing with the real risks facing the company, which in behavioural terms creates irritation with 'stupid' rules and so does not assist compliance with the spirit of the law.

Some respondents argued for some level of exemption from SOX section 404 for smaller companies, or if not for all smaller companies, for newly listed businesses or those seeking listing. The grounds for such arguments were based principally on cost. The AEA, for example, referred to the 'massive and disproportionate burden for small companies', and, disparagingly, to the 'one size fits all' approach to the audit of controls and described the burden of cost as 'a major regressive tax on small business'. Barbara Hackman Franklin cited the case of 'a fledgling biotechnology company, with no products yet on the market' which had spent 4-5% of its available cash on SOX section 404 compliance. Crowe Chizek, a smaller audit firm, expressed concern that the high level of cost might

deter smaller businesses from entering capital markets to obtain finance, or from maintaining their existing status as listed companies.

However, others argued that there should be no size-related exemption from the general SOX section 404 requirement. Glass Lewis, for example, cited evidence that showed that smaller companies were more likely to report material weaknesses than large companies, and that their financial statements were more likely than those of larger businesses to require restatement. Also, the firm argued that provision of information was an obligation that should not be avoided:

When a company takes money from the investing public, they agree to an obligation to provide timely and accurate information, regardless of their size.

Actual and predicted consequences of SOX section 404

Several respondents expressed concerns about the actual and potential consequences of SOX section 404. These included:

- Redirection of resources to unproductive activities (e.g. MBA);
- Inhibition of economic growth (e.g. MBA);
- Over-auditing, resulting in significant cost to investors (e.g. Plum Creek Timber Co);
- Threat to the competitiveness of US business (e.g. Caterpillar);
- Possible withdrawal of foreign registrants from the US capital market (e.g. AEA); and
- Delay in filing annual reports because SOX section 404 implementation incomplete (e.g. Standard and Poor's, the credit rating agency).

However, some positive consequences were also cited by respondents:

- Investor protection has been strengthened (e.g. Ohio Public Employees Retirement System – OPERS); and
- Additional focus on the importance of proper controls by companies (e.g. Crowe Chizek).

Discussion of SOX section 404: weaknesses and problems

There can be no doubt, on analysing the responses to the SOX section 404 consultation, that this has been a highly controversial piece of legislation. The argument that attention to internal controls was long overdue, and that the huge efforts required in 2004 were simply making up for years of neglect, is persuasive. However, SOX generally and section 404 in particular, were promulgated in order to address the weaknesses exposed by the well-known corporate scandals of the late 1990s and beginning of the twenty first century. The relatively narrow focus on ‘process level’ financial controls does not necessarily address those weaknesses or help to prevent the future collapse of large corporations. The cost of SOX section 404 compliance in its first year was perceived as a significant burden by many of the respondents, and it seems likely that some element of the cost was occasioned by the fact that corporate management and auditors were conducting the exercise without full knowledge of what the detailed regulatory requirements would be.

The regulation that was eventually issued during 2004 in the form of AS2 may have failed in its overall intention because its definitions of what constituted material error were, clearly, open to interpretation. It was not to be expected that the US auditing profession would respond other than defensively to any new auditing requirements in the

circumstances following recent corporate collapses and scandals. The period of expiation necessary as a corrective to these major events was always likely to be both severe and prolonged in nature.

The next section of the chapter examines the recommendations and proposals made by the respondents to the consultation exercise.

Recommendations and proposals

Given the volume of comment received from the respondents to the consultation, a substantial number of recommendations and proposals were only to be expected. Some of the principal categories of recommendation are identified and discussed below.

Recommendation to maintain SOX section 404 with few, or no, changes

Recommendations of this type were made by a minority of respondents. OPERS made an unequivocal statement of support:

We urge the SEC to leave Sarbanes-Oxley intact and reject any proposal by its critics to weaken this important investor protection legislation, including section 404.

Glass Lewis suggested that the SEC and PCAOB should undertake an assessment of the benefits that have accrued to investors as a result of SOX section 404 so that an informed analysis of cost/benefit can be undertaken. The firm also suggested that implementation guidance should be provided but supported the regulation, stating a belief that revisions to SOX section 404 and AS2 were not warranted.

Additional implementation guidance should be provided

Deloitte, for example, made many proposals for further guidance and additional clarification in such areas as the scope of testing required for both management and auditors, the nature and extent of evidence required, and the nature of documentation of internal controls. Improvements to the definition of terms were suggested by Barbara Hackman Franklin:

The wordy definitions of ‘significant deficiency’ and ‘material weakness’ are not beacons of clarity. ... What is ‘more than a remote likelihood’ that a misstatement might occur?’

However, Glass Lewis expressed some concern about the level of detail that some respondents had requested as additional guidance, pointing out that this would lead to an expansion of existing standards and would run counter to a principles-based approach.

Greater reliance on the work of others should be permitted

This was suggested as a practical measure by many respondents. For example, FEI suggested that external auditors should be permitted, where appropriate, to rely upon procedures performed by management and internal audit.

Less frequent testing should be permitted

The IIA and many others suggested that testing of internal controls should be permitted to be undertaken on a cyclical basis, perhaps over several years.

A risk-based approach to the audit of internal controls should be permitted, and due regard should be paid to the concept of materiality

Westpac's suggestion in this respect was quite typical:

...it would be far more effective to allow a risk-based approach to the testing of the operational effectiveness of controls by both management and external auditors to ensure that effort is focused on those areas with higher inherent risk of misstatement.

Rules should be changed to allow exemptions for smaller companies and foreign issuers and those companies that are about to list, or are newly listed

Standard and Poor's, for example, hoped that:

... the Commission will further address the potential hardship to smaller entities and foreign private issuers...

And several suggestions were made about appropriate cut-off points for smaller company classification. Independent Community Bankers of America (ICBA) advocated an exemption for publicly held community banks with assets under \$1 billion, and the AEA suggested that SOX section 404 should be suspended, at least temporarily, for all companies with revenues of under \$1 billion.

Move towards principles-based, rather than rules-based, regulation and guidance

Several respondents mentioned the desirability of adopting a principles-based approach to the SOX section 404 work, which should permit both management and auditors to exercise greater judgement.

Omissions from the analysis

The responses to the consultation on the Turnbull guidance were usually structured around the seventeen questions that were asked as part of the process. This led to some uniformity, even predictability, in the nature of the responses, and tended to influence and guide the content. There was no such constraint in the case of the SOX section 404 consultation, with the result that the responses were much more varied in nature. They ranged from very short e-mails, sometimes little more than a line or two, to very lengthy and elaborate documents. The topic coverage was much greater, although in some cases the subject matter of the responses was tangential, at best, to SOX section 404. Therefore, omissions from the analysis offered by the consultation responses are perhaps less easy to identify than in the case of Turnbull.

Nevertheless, some omissions did become obvious as a result of the detailed analysis, especially when comparing the key issues arising between the Turnbull and SOX section 404 consultations. A fundamental point is that there was virtually no questioning of the pre-eminent role of legislation in addressing corporate failure. Interested parties in all categories appeared to accept that legislation, and related quasi-legislative regulation such as AS2, was the correct approach and there was no suggestion that voluntary codes and 'comply or explain' could be appropriate responses. The questions that preoccupied respondents related to the nature of the legislative response and its working out in practice. On occasion, respondents proposed that a more principles-based, rather than rules-based approach should be adopted, but this was often in the context of asking for more, rather than less, detailed guidance, a request which would appear to run counter to the spirit of a principles-based approach.

Although there was some recognition of the narrow view of internal control that is integral to the SOX legislation (i.e. that it is restricted to control over financial reporting), only a few respondents appeared

to think that it would be helpful to take a broader view of control. Although there was support for risk-based approaches to auditing, the broader concepts of 'risk' and of 'risk management' which permeated the Turnbull consultation responses (see chapter five of this report) were mentioned only infrequently by the SOX section 404 respondents. There were few references to the COSO framework.

The comparison of the Turnbull and SOX section 404 consultation responses lends support to the view, discussed in chapter two, that there are significant differences, despite the widespread assumption of similarity, between US and UK models of corporate governance.

Response style

As a final addition to the analysis, this section adds some issues that are suggested more by the tone and style of the analysis than by its content. Reflecting upon their experience of coding the responses from both of the consultation exercises under review, the researchers concluded that there was something to be learned from certain stylistic features of the responses. A framework comprising three principal stylistic strands was identified as a result of reflection and discussion: emotional, conjectural and evidence-based. Many of the SOX section 404 responses were very well written, with clear articulation of their arguments. They were courteous in tone, and often contained very formal thanks for the invitation to contribute to the consultation. On the other hand, some responses, usually the shorter ones, were much less literate. Elements of all three stylistic strands were in evidence in these responses, as detailed and discussed below.

Emotional

Even in the most polite and stately responses, the use of vocabulary sometimes demonstrated the exasperation felt by respondents. Some

examples of words and phrases will help to convey the tone and content:

- ‘Nitpicking’ (this one from the UK’s CBI)
- ‘Consternation’
- ‘Made life unnecessarily difficult’
- ‘Stifled motivation’
- ‘A bad regulation’
- ‘Compliance burden’
- ‘Bureaucratic mechanisms’
- ‘Weakening capital’
- ‘Permanent damage to competitiveness’
- ‘Undermining our country’s economic growth’
- ‘A limitless necessity to document, document, document rather than to do, do, do’
- ‘Massive cost for little value’
- ‘Huge strain on our firm’s resources’

All these examples are taken from the responses that were selected for detailed examination as part of this research. The emotional content of some of the responses that were not subject to detailed examination was much more striking in places. For example:

- ‘PCAOB – a bureaucratic boondoggle’
- ‘increasing concern over the HORRENDOUS effects that the Sarbanes-Oxley legislation is having...’
- ‘... our audit firm... is trying its darndest to stir up issues that honestly DO NOT EXIST’

- ‘THIS IS DECIMATING THE SMALL CAP MARKETPLACE’
- ‘Sarbane-Oxley (sic) is a huge waste of time and money. All the SEC had to do ... is to force executives to do hard time when found guilty... none of this Camp Cupcake stuff...!’

There is a striking contrast between the unemotional tone of the Turnbull responses, and the tone of some of the responses to SOX section 404. While this difference could possibly be attributable to cultural differences between the USA and the UK, it is quite likely that the more emotional response on the part of many US respondents is due to the fact that SOX section 404, and the financial scandals the legislation was intended to address, have had major economic consequences.

Conjectural

The most striking examples of conjectural responses in the SOX section 404 consultation were found in the prediction of the dire consequences that could ensue from it. These were often expressed in terms of threats to the US economy, and perhaps reflected more fundamental fears of the effects of economic globalisation. Universal Corporation expressed concerns about how the SOX section 404 costs were to be absorbed:

...costs being passed on to consumers or offset perhaps by transferring US jobs to lower wage countries or reducing corporate philanthropy, or accepting diminished returns for their shareholders.

The theme of damaging American competitiveness cropped up again and again. The AEA, for example, expressed its concerns thus:

Skyrocketing implementation costs have put high-tech companies in the position of having to delay major projects at a time when many are struggling to compete with low-cost competition from Asia and with escalating medical costs.

The conjectural was often, as in this quotation, tied to the emotional. The messages conveyed in such responses reflected fear, insecurity and doubt about the future. SOX section 404, while it undoubtedly has had serious consequences, perhaps presented an opportunity for some respondents to express more deep-rooted fears and concerns.

Evidence-based

Respondents to the SOX section 404 consultation were more likely to refer to named sources of evidence than Turnbull respondents. Some included copies of reports and their own research as part of their responses. Glass Lewis, for example, appended a detailed report on internal control deficiency disclosures to an already quite lengthy response. Many respondents referred to a study by FEI especially in relation to the costs of complying with SOX section 404. Other examples include the IIA response, which included two lengthy papers relevant to the discussion, and the ICBA which referred in its response to a recent survey conducted amongst its members on SOX section 404. References to academic literature were, however, sparse.

Summary and key issues

The SOX Section 404 consultation process was much more open-ended than the equivalent Turnbull consultation, and it therefore elicited a much more varied type and length of response. Many respondents, especially those from the investor community and its representatives, expressed support for the objectives of SOX section 404. However, there were few expressions of unequivocal support and auditors, companies and industry representative groups were often highly critical of weaknesses that they had identified in the new regulation.

The principal problem identified was that of cost. Almost all respondents identified at least some commensurate benefit but doubt

was frequently expressed about the balance of cost with benefit. The high levels of cost experienced by public companies in 2004 was attributed by some parties to the years of neglect of internal control systems that had preceded it. Views were mixed about whether or not the magnitude of cost could be expected to reduce in subsequent years, but most parties agreed that some reduction was to be expected. A significant contributory factor to the initially high level of cost was the delay in issuance of AS2 which did not appear until part way through 2004, and which was not formally approved by the SEC until June of that year. Additional guidance continued to appear throughout the remainder of 2004.

A further problem that was frequently cited by respondents was the change that SOX section 404 created in the auditor/client relationship. Auditors were perceived by many to have adopted a highly defensive stance in their interpretation and application of the regulation. They were unable or unwilling to exercise judgment in such matters as the determination of control adequacy. Several companies criticised auditors for their failure to integrate the audit of internal controls with the normal financial audit. A greater distance was apparent between auditors and their clients, although this was seen in some quarters as a helpful development.

AS2 was subject to much criticism for its lack of clarity about the definition of, for example, materiality and material weakness which was perceived by some to have led to excessive levels of audit testing. The standard appeared to preclude the possibilities of external auditors placing reliance upon the work of others, and to require a completely fresh audit of internal controls each year.

Some specific problems were identified relating to the scope of the regulation in respect of smaller listed companies and foreign issuers.

There were many recommendations for amendments to the regulation. While most respondents applauded the general intention of SOX section 404 many were very dismayed by the level of compliance costs experienced, and by the potentially dire consequences that many

of them predicted, for example, relative loss of competitiveness of US business and inhibition of economic growth.

The principal omission from the analysis observed by the researchers was any serious degree of questioning of the pre-eminent role of legislation in addressing failures in corporate governance. This contrasts markedly with the UK approach to corporate governance with its voluntary code. Also, while there was a limited recognition by some respondents of the importance of risk management and the possibility of taking a broader view of control systems, most respondents to the consultation did not question the comparatively limited scope of control addressed by the SOX section 404 regulation.

The tone of the responses and vocabulary used were quite often emotional, in the sense of demonstrating exasperation with the regulation and its implications. Emotion was sometimes combined with conjecture, principally when predicting the dire consequences that could arise in the form of threats to US competitiveness. Compared to the Turnbull consultation responses, the SOX section 404 responses were more likely to be based on evidence in the form of research reports, although the absence of references to academic research was noticeable in both sets of responses.

5 FINDINGS: TURNBULL REVIEW GROUP CONSULTATION

Introduction

As in the previous chapter, three aspects of the response to the Turnbull Review Group consultation will be examined. The first, and by far the longest, section of the chapter examines and analyses the content of the responses. The second section examines omissions from the responses, that is, ‘what they don’t say’. The final section examines the style of the responses – ‘how they say it’ - discussing the extent to which the responses can be regarded as emotional, conjectural and evidence-based.

As noted earlier, the Turnbull responses differ from those of the Sarbanes-Oxley respondents in the respect that the former are generally structured around the seventeen specific questions posed by the Review Group. This chapter is organised thematically, without particularly close consideration of the individual questions. Appendix C provides, against each question, an outline of the tenor of the responses to it. Appendix C, read in conjunction with this chapter, should provide some element of triangulation.

Principal themes emerging from the consultation

The codes emerging from the analysis of the data were grouped around headings that emerged in the course of the coding exercise.

Turnbull: strengths and weaknesses

It rapidly became clear in the course of coding that most respondents were inclined to express views as to the extent to which the Turnbull guidance could be regarded as a success. Opinions emerged as a result of many of the questions, but were also quite often summarised as part of a covering letter.

Many respondents articulated their feeling that the Turnbull guidance had, overall, been a success (with some using terms such as ‘outstandingly successful’), and that it had achieved its objectives. Approbation was expressed of features such as: the guidance’s adaptability; its ‘common sense’ approach; the perception of it as ‘principles-based’ rather than ‘rule-based’; and the effect that it has had in increasing the board’s attention to risk evaluation. Correspondents generally approved of the guidance’s flexibility, and the breadth of the framework it offers. Some correspondents pointed out, approvingly, that the guidance has had significant influence beyond the constituency of listed companies at which it was originally aimed, on other sectors including the public sector.

Some commentators expressed adverse opinions, although these were usually leavened by a great deal of positive comment. Dissatisfaction with disclosure was mentioned quite frequently: criticisms frequently used the word ‘boilerplate’ as a term of opprobrium, suggesting that disclosures were formulaic and uninformative, with some companies simply copying disclosures from each other and providing very little useful information. Concern was expressed that little additional information was provided to shareholders, and that the guidance and the resultant annual report disclosures had been treated as a box-ticking exercise that failed to improve transparency.

Specific strengths and weaknesses are discussed in more detail below under the sub-headings ‘Risk awareness and risk management’, ‘The role of boards, non-executives and auditors’, and ‘Disclosure and the investor perspective’.

Risk awareness and risk management

Respondents often claimed that an important effect of the Turnbull guidance was that it had increased overall awareness of risk at board level in listed companies. Investors, auditors and companies all made similar observations on this point. Positive claims were also made for risk awareness at other levels in the organisation. For example, Ernst & Young observed that:

... the existence of the Turnbull guidance, and the process that companies have put in place to implement the guidance, has assisted all levels of board, management and staff, but particularly non-executive directors, gain a better understanding of the company and enable them to operate more effectively in their roles.

Similarly, a corporate respondent, Anglo American plc, identified a greater acceptance amongst managers and other employees to integrate risk and control practices into their day-to-day responsibilities, and Scottish Power plc reported more effective risk management at all levels within the business.

In consequence of the increased awareness of risk, it was frequently claimed that risk management had improved. For example, Marks & Spencer plc noted that the company was very much more aware of risk because of the guidance and that it now had a greatly increased determination to proactively manage risk. An investor organisation, Standard Life, affirmed that it had observed boards paying increased attention to risks, and to assessing the controls associated with those risks. On the other hand, as might be expected, some businesses reported that their risk management and internal controls had changed very little because of the Guidance, because they were already subject to high levels of focus.

However, while accepting that risk management in general has improved as a result of the Turnbull guidance, some respondents were more sceptical. The Institute of Internal Auditors (IIA), for example, pointed out that most organisations had made no attempt to measure the benefits of risk management activities.

Several respondents referred to 'high level' risk assessment and risk management, pointing out that risk management transcended a narrow focus on internal control. Many demonstrated a keen awareness of the contrast between the Turnbull guidance and the Sarbanes-Oxley legislation in this respect. The ACCA, for example, recommended that any changes to the Turnbull guidance should continue to focus upon wider aspects of internal control as opposed to internal control over financial reporting. Morley Fund Management, while recognising that the impact of legislative reforms in the USA had still (at the time of writing) to be assessed, opined that the focus of the US approach was too narrow.

Some respondents identified a reduction in effectiveness with the passage of time since the original implementation of the guidance. The Institute of Risk Management (IRM), for example, observed that the profile of risk management had diminished, after an initial period of high activity. The IRM, the ACCA and the IIA all used the term 'paying lip service' to describe the rather sketchy approach to risk management and related issues within companies. Some of the corporate respondents noted the limited help provided by the guidance in establishing a risk framework. Anglo American, for example, said that companies had needed to develop their own methodologies at significant cost, and the Quoted Companies Alliance noted that the time and effort required to identify risks had been a major practical problem for smaller companies.

The role of boards, non-executives and auditors

Some respondents reported positive impacts arising from the guidance in relationships between the executive and non-executive members of corporate boards, and with the internal and external auditors.

The CBI noted that more and more companies have established an internal audit function, and that the profile of internal audit has tended to increase. Deloitte observed approvingly that the Turnbull guidance has resulted in a positive impact on internal audit. Discussion of external audit tended to focus upon the specific questions asked in the consultation (questions 14, 15 and 16: see appendix C) in respect of the external auditors' remit. While some respondents could see advantages in extending that remit, they usually observed that the potential benefits would be outweighed by the additional costs incurred, and some noted that any extension of external auditor duties, for example, reporting on the effectiveness of internal controls, was unlikely to be feasible without a change in the auditor liability regime. The Vodafone plc response pointed out that any extension of the external auditor's role to incorporate auditing of non-financial controls would require substantial additional and costly investment in training, systems and personnel. A further additional risk, pointed out by the London Society of Chartered Accountants, was that investors would be inclined to see an internal control effectiveness statement from the auditors as 'a watertight guarantee that nothing could go wrong'. On the other hand, Pensions & Investment Research Consultants Limited (PIRC) described the current role of auditors in relation to internal control as 'woefully inadequate'.

Hermes approved of the positive effect of the Turnbull guidance on non-executive directors:

From our knowledge of investee companies, the guidance seems to have had extremely positive impacts and to enable good non-executives to become confident about internal controls at their company.

The CBI pointed out that audit committees had benefited from the Guidance, and it had provided a 'useful tool' for non-executives in that it had given them a framework within which they could ask for details of management's risk analysis.

With few exceptions, no radical alteration was proposed to the current level of guidance offered by Turnbull. However, some criticisms were offered of boards in general. The Institute of Risk Management's response noted boards' 'head in the sand' approach to risk management, and claimed that companies tended to focus only on those risks that they could actually deal with. The IIA noted that not all boards considered risks in making strategic decisions, and Standard Life noted their concern that the increasing importance of board committees should not undermine the responsibility of the board as a whole and of individual directors in fulfilling their responsibilities relating to internal control.

Disclosure and the investor perspective

There was a general view amongst respondents that the level of disclosure required by the Turnbull guidance was of limited or no value for investor decision making. The Hermes response pointed out that few disclosures extended beyond a close reproduction of paragraph 37 of the Turnbull guidance. PIRC dryly commented:

The Turnbull Committee was concerned to avoid shareholders being subjected to 'voluminous disclosure'. We believe it is safe to say that this has not been an issue.

Vodafone plc noted that there was, in any case, a significant time lag between the occurrence of any control weakness and the final publication of disclosures about internal control. Many respondents noted the anodyne nature of current disclosures, using terms such as 'ritualised', 'generic' and 'boilerplate'. The value of disclosures for institutional

and large private investors was likely to be minimal in any case because they would derive more value from face-to-face contact with corporate managers.

A smaller number of respondents, however, found some value to investors in the disclosures for the purposes of accountability and managerial stewardship. Marks & Spencer's response, for example, specifically mentioned the value of disclosures in providing evidence of management's stewardship. Also, the obligation to make the disclosures, it was suggested, would have the effect of focusing managerial attention on risk management:

It is the fact of disclosures of whether the company's processes are consistent with the Turnbull guidance rather than the detail of disclosure which has the most effect on focussing boards' minds on the need to consider risk management processes. (CBI)

Many correspondents considered the question of whether or not additional disclosure would be helpful, and the prevailing tendency was to conclude that it would not. Reasons for this conclusion included the following:

- Extended disclosures would not facilitate decision-making (CBI and ICAEW);
- Fear that it would 'open the door' for litigation on a highly judgemental matter (Anglo American);
- Institutional investors would in any case place more value on direct communication with the company (ACCA);
- More disclosure might lead to 'many pages of, at best uninteresting and at worst self-serving, disclosure (QCA); and

- More specific disclosures could result in undue concern by investors and could be taken out of context (Reckitt Benckiser).

There was some limited support for increased disclosure, notably from some investor organisations. Hermes, for example, inclined to the view that disclosures could add value that would assist in investor decision making.

Suggestions and recommendations

Although many respondents made suggestions and recommendations for amendments to the Guidance, there was no discernable impetus for any radical change whatsoever. Respondents were content that the guidance should continue to cover all controls, to be principles-rather than rules-based, and to be pitched at a high level. All categories of respondent were in favour of maintaining the guidance in its current form, with only relatively minor changes. Many responses urged the importance of avoiding a ‘checklist’ mentality, ‘boilerplate’ disclosure and any prescribed form of reporting. Positive recommendations included the following:

The guidance should cover all categories of risk

Marks & Spencer, BP and ACCA, for example, all advocated that both upside and downside risk should form part of the risk assessment and management processes. PIRC suggested that it was appropriate to cover all risks, including consideration of recurring risks:

... there is a risk of the focus on the potentially catastrophic once in a hundred year risk rather than more prosaic risks.

In order to better reflect the substance of the guidance, the title should be changed

Marks & Spencer suggested a change to ‘Risk Management, including Internal Control’, and similar suggestions were made by other respondents.

Clarification and explanation of some of the key terminology used in the Guidance

ACCA, for example, suggested that a glossary of terms should be added, and respondents asked for definitions of such terms as ‘risk’, ‘risk management’, ‘risk appetite’, ‘risk assessment’, ‘materiality’ in the context of, for example, ‘material controls’.

The need for the guidance to embody an appropriate control framework

For example, Marks & Spencer suggested reference to the IRM’s Risk Management standard, COSO’s Enterprise Risk Management framework and Australian/New Zealand standard AS/NZ 4360.

It was noticeable that the tone of the recommendations was in a uniformly minor key, consistent with the commentary in general. The approach taken in the guidance appeared to meet with widespread approval throughout the various user groups that had responded to the consultation.

Omissions from the analysis

US and UK corporate governance regulation, as referred to in several places in this report, differ substantially from each other. Therefore, it is not to be expected that the concerns of the respondents in the consultation exercises would necessarily be the same. A comparison of

the principal themes emerging from the analysis produces omissions which may be revealing. This section therefore examines what is not said, or at least rarely said, by the Turnbull respondents.

A key point of concern that emerged in many of the Sarbanes-Oxley responses was that of cost, especially amongst the corporate group (see chapter four of this report). Considerations of cost, though, figured rarely in the analysis of the Turnbull responses. The cost burden on smaller listed companies was mentioned briefly, as was the cost of employing consultants, but neither issue was raised frequently. The lack of comments relating to cost suggests that the burden of ensuring compliance with the Turnbull guidance was not seen as significant. The omission may also suggest that the effort involved is not great, and that compliance is a matter of relatively minor significance.

Another significant omission occurred in respect of the relationship with auditors. Some concern was expressed in the Turnbull responses about difficulties that might ensue if the remit of the auditors were to be extended. However, such difficulties did not apparently concern respondents at the current level of guidance. By contrast, a major cause of concern to the Sarbanes-Oxley corporate respondents was that their relationship with their audit firms had been damaged or compromised to the point where they are unable any longer to seek guidance on the application of GAAP. Concerns expressed by Sarbanes-Oxley respondents are actual and immediate whereas the concerns of the Turnbull respondents are largely speculative and conditional in nature. It might therefore be concluded that the relationship between auditors and listed company boards in the UK has remained largely unchanged as a result of the Turnbull guidance.

Response style

The equivalent section in chapter four identified three principal stylistic strands observed by the researchers while conducting their analysis: emotional, conjectural and evidence-based. The predominant

stylistic feature of the Turnbull consultation responses was that they were likely to be conjectural in nature being based upon beliefs and impressions. Although there are exceptions, the reports of most of the correspondents are impressionistic in style, and are, typically, not research-based in the sense of referring to an independent body of evidence. Examples of this stylistic feature abounded. They included:

- ‘...anecdotal evidence... leads us to believe that...’;
- ‘We believe (the Guidance) has succeeded in its objectives...’;
- ‘Yes, we believe that the objectives of the Guidance... have been achieved...’; and
- ‘...the need to review risk at board level has probably led to a better understanding of risks and controls’.

The texts of the responses frequently used such expressions as ‘we believe’, ‘probably’, ‘largely’ and ‘perhaps’.

It was relatively unusual to find any reference to research of any kind and certainly not to academic research. One of the few exceptions was provided by the response of the Institute of Internal Auditors which referred to on-line surveys of members’ views and ‘facilitated discussions’. Although there were occasional references to the need for further research to inform developments in the guidance, recommendations and suggestions were made on the basis of impressions gained from one organisation’s experience. This approach by no means invalidates the responses, but the lack of a research base or, in most cases, any recognition that a research base might be useful, suggests that respondents are satisfied with an ad hoc, pragmatic, approach to developments in corporate governance.

The responses were not characterised by expressions of strong feeling on the issues discussed; there was a lack of emotional engagement. It can

certainly be argued that issues relating to risk management and internal control are unlikely to evoke emotional responses, but the results of the Sarbanes-Oxley consultation provide something of a contrast in this respect.

Conclusions on response style

In general, the style of response from the SOX section 404 consultation exercise was observed to be much more variable than that elicited by the Turnbull consultation. While there was, naturally, some conjecture particularly in respect of predictions about the consequences of the regulation, it was noticeable that respondents were more likely to refer to evidential material. The emotional range of expression was much greater, probably because the regulatory impact was so much greater in the USA than in the UK.

Summary and key issues

The structured nature of the consultation on the Turnbull guidance, with its seventeen questions, determined in most cases the structure and content of the responses received. It could be argued that more meaningful responses could have been elicited by using a more open-ended approach. However, this could have resulted in fewer responses overall and, considering the number and range of organisations and individuals affected by Turnbull, the responses were not, in any case, numerous. Besides, respondents were not absolutely obliged to structure their answers in a particular way, and any very strong feelings about the issues under review would have been likely to emerge regardless of the structure.

The most significant general criticism to emerge in the consultation was a dissatisfaction with the nature of the disclosures which was felt by many commentators to be anodyne and of little, if any, practical use.

However, although some respondents favour more discursive disclosures, the perennial problem remains of how to achieve them without increasing exposure to liability.

It is clear that the Turnbull guidance has succeeded in raising the profile of risk management at board level and sometimes, although not always, at other levels in companies. Whether or not this raised profile has actually improved the management of risk cannot be readily ascertained, but boards are apparently content to formally consider risk in a more systematic way.

Recommendations for improvements to the guidance are consistently low-key and relatively limited in nature. There is no indication that radical reform is required.

A consideration of omissions from the analysis furnishes some possible reasons for the rather bland and unexciting nature of the responses to the consultation exercise. Implementation cost is not a major issue, and relationships between key players such as auditors, board committees and board members appear to have been little affected. In the circumstances, and in the absence of the need to address shortcomings following a major financial scandal, it is unsurprising to find no impetus for radical change.

Few of the responses to the consultation are based on a solid grounding of evidence, and there is virtually no reference to relevant, rigorous research. They are often couched in terms that suggest reliance almost exclusively on anecdote and impressions. While these accounts can be useful in illustrating issues by reference to experience in particular organisational contexts, their wider applicability is, of course, questionable.

In the next chapter the findings set out in chapters four and five are compared and contrasted.

6 IMPLICATIONS

Introduction

In this chapter, the findings described in the two previous chapters are compared and contrasted. The analysis set out in the two previous chapters is based on the categories developed from the separate coding of each set of data. Comparing those categories across the data sets, the following broad areas of particular contrast are identified:

- the role of regulation;
- the interpretation of internal control and its relationship to risk management; and
- impacts of the guidance/legislation at organisational level, including:
 - costs incurred by disclosers;
 - changing relationships with auditors; and
 - the impact on audiences for disclosure.

These areas form the basis for the comparison which follows. The implications of the differences are discussed, leading to some reflections on the role of consultation in the development of regulatory policy.

The role of regulation

There is a distinct difference between the US and the UK in the role of disclosure within a regulatory framework. The US regime prescribes the form of disclosure within the panoply of legislative requirements relating to corporate governance: disclosure is a **part** of regulation. In the UK, the form of disclosure is far less prescriptive and disclosure is effectively the regulation, an alternative to legislation. In its focus on risk management, the UK disclosure regime potentially leads to some transparency as companies describe their internal processes. In the US system, the certification process established under SOX is oriented to defensive compliance rather than transparency.

The Turnbull guidance was generally judged by respondents to be very successful, particularly in raising the level of risk awareness in companies. The reiterated appreciation for the principles-based and flexible nature of the guidance might suggest that part of this impression of success related implicitly to the avoidance of a SOX-style legislative requirement relating to internal control disclosure. Two respondents made this point explicitly:

If the guidance is not seen to drive and deliver the benefits of sound risk management and better business performance swiftly, then we may find the more prescriptive US approach adopted by continental Europe and imposed on the UK through the EU.
(Marks and Spencer)

What is clear is that we need to agree the approach to Corporate Governance in the UK, a clear strategy needs to be adopted, so that we are ready to enter and influence the European debate on the subject with a set view. Failing the adoption of such a strategy, it was believed that the US approach will overwhelm Continental Europe and be imposed on the UK through the EU. (Institute of Risk Management, reporting the views of members)

Monitoring and enforcement under a ‘comply or explain’ regime relies on market forces rather than legislative structures and the data examined in this study suggest that the existing UK system is viewed as entirely appropriate for internal control disclosure by both preparers and audiences. The SOX section 404 respondents do not suggest any major move away from the US legislative framework for addressing corporate governance issues, although some do recommend the adoption of a more principles-based approach. This raises the question as to whether there is a common understanding of the meaning of ‘principles-based’. Within the Turnbull discussion the expression ‘high level’ appears (perhaps prompted by its use in question 4 – see appendix C) but the meaning of this remains vague and unclear.

The interpretation of internal control and its link to risk management

The link between internal control and risk management was the most significant contrast between the conceptions of internal control in the UK and the US. Risk awareness and management were a central focus for the Turnbull respondents but did not feature in the same way in the comments on SOX section 404. This reflects the close identification of internal control with risk management in the wording of the Turnbull guidance and the consequent broader interpretation of the meaning of internal control in the UK than in the US. Although the latest version of the US COSO framework focuses on enterprise risk management, the narrow interpretation of internal control, as developed by the US auditing profession to clarify the boundaries of their responsibilities and embedded in SOX, bears little relation to the UK view of internal control as a key means of managing risk and enabling company objectives to be achieved. Some Turnbull respondents noted this difference, expressing a distinct preference for the UK approach.

The US focus on internal control as the key feature of a compliance process suggests that concern about costs will be inevitable as it is more difficult to identify benefits arising from compliance processes which are directed at providing assurances of company probity to external audiences. The UK approach suggests that, where internal control is seen as closely related to risk management, there may be a clearer sense of its value to the business.

Impact of guidance/legislation at organisational level

Costs incurred by disclosers

A major preoccupation of SOX section 404 respondents was the increased cost of compliance; at the organisational level, many considered that this would outweigh the benefits identified. Although, as noted in chapter two, internal control had been a continuing public preoccupation in the US for far longer than in the UK, evaluating and reporting on those controls has not been mandatory and, as a result of SOX, US company boards and auditors saw a need for extensive investigation and documentation of systems to underpin certification. Some of these costs were exacerbated by systemic problems relating to the timing of the legislation and the need for guidance for auditors from the newly established PCAOB. Views were divided as to whether costs would decrease after the initial investment in compliance processes or whether the high level would persist into subsequent years. At a broader level, some respondents expressed concern about the impact on the competitiveness of US companies and capital markets.

In contrast, there was little reference in responses to the costs of ensuring Turnbull compliance, suggesting that there was already widespread confidence among boards of directors in their companies' internal control systems and little need for system adjustment or extra inspection beyond that already in place through internal audit. One

can only speculate as to whether this sanguine view would have been maintained if directors of UK companies had been required to provide certification subject to SOX-type penalties.

Changing relationships with auditors

As discussed in chapter five, there was a big difference between the two sets of responses relating to the relationship that companies have with their external auditors. SOX section 404 respondents from the corporate sector had experienced a significant shift, a reflection of audit firms' response within a changing and to some extent uncertain regulatory environment. A notable observation by Turnbull respondents related to the increased profile of internal audit – another contrast with the US environment where the SOX section 404 respondents made little reference to the internal audit role.

The Turnbull guidance is specifically directed at boards and many of the questions posed in the consultation mention boards (see appendix C) so it is unsurprising that respondents focused on the impact on boards of directors. Although there was much support for the view that the guidance had increased risk awareness at board level, boards were also criticised for lack of attention to risk management and for the poor quality of information disclosure in boilerplate reports. SOX section 404 respondents had little to say about board roles although some observed that the concentration on lower level controls arising from the requirements of AS2 would not be enough to prevent ethical lapses of the sort which had led to recent US financial scandals, recommending that more attention should be paid to the 'tone at the top'.

Although some Turnbull respondents noted that the guidance was of considerable assistance to non-executive directors in providing them with assurance about risk management systems, neither group of respondents had much to say about the impact on audit committees which, given the emphasis on the role of audit committees as a corporate governance oversight mechanism in both countries, is perhaps surprising.

Impact on audiences

One measure of the success of the Turnbull guidance cited by some respondents was its influence beyond the private sector and the adoption of the guidance in public sector organisations. However, the major criticism of the Turnbull guidance related to the usefulness of the disclosures themselves. Many concerns were expressed about 'box-ticking' and boilerplate, although some respondents perceived some advantage to be gained from the process of disclosure, citing an improvement of risk awareness at board level arising from the need to disclose.

Section 404 of SOX was judged by respondents to have performed a very important role in boosting investor confidence and public trust in companies but some concern was also expressed by respondents about the consequences of SOX section 404 at a broad level - for example the impact on US business competitiveness and the consequences for the US capital market of the possible withdrawal of foreign registrants.

The sample of responses examined in this study is too limited to permit any broad generalisations about the impact of the guidance/legislation, although the responses analysed cover a range of potential audiences. The academic literature on the impact of disclosure is extensive but suggests that, with so many variables to take into account, this is very difficult to model. The data examined in this study suggests that increased internal control disclosure may not be desirable for all audiences as different groups of interested parties will have different information needs and priorities.

The role of consultation in framing regulation

The rough classification of responses between conjectural, emotional and evidence-based suggests that US respondents tend to express themselves more emotionally and also to offer responses based

on more substantial evidence than those in the UK. These apparent differences prompt questions about the process of the consultation exercises undertaken.

The UK Financial Reporting Council (FRC) was prompted to review the Turnbull guidance in the wake of US experience post-Enron. The consultation responses demonstrate a significant concern about the possibility of the introduction of a legislative regime, a concern that has implicitly underpinned discussion of appropriate corporate governance mechanisms since the establishment of the Cadbury Committee in 1992. A 'principles-based' system centred on a voluntary code which encapsulates 'best practice' has met with much support and the UK has not experienced financial scandals which might test its adequacy in terms of the level and quality of information disclosure. This consultation exercise allowed the FRC to affirm the status of the Turnbull guidance and to demonstrate a continuing concern that the guidance should remain relevant and be adjusted as necessary. During 2007 a similar consultation was conducted as part of a review of the Combined Code as a whole and responses have been posted on the FRC web site. This form of public consultation is relatively new in the UK. In contrast, in the US it has long been the established practice of the SEC to invite public comment on proposed implementation Rules and the SEC website contains considerable detail about Rule development, including staff comment on consultation responses.

Consultation responses appear to be only a part of the data used by regulators and policy makers in both countries in their deliberations but the extent of the influence of these responses is unclear. How is the information analysed and assimilated? Do differing stylistic approaches in responses affect their interpretation? Does the content of the responses carry real weight or is the process of consultation more important as a way of managing the credibility and legitimacy of the regulatory outcomes?

Summary

In drawing out the areas of particular contrast between the two sets of consultation responses, this chapter has highlighted differences between the two regulatory regimes in terms of perceptions of the role of disclosure as a tool of regulation, the impact of regulation at both national and organisational level, especially with regard to costs and altered relationships, and in the interpretation of internal control and its relationship to risk management. The stylistic differences in the responses also suggest that the role of consultation in developing regulatory policy could be fruitfully investigated further.

Differences in each of these areas prompt broader questions about the possibility of corporate governance convergence. The US and UK systems are thought to have much in common and are frequently referred to as ‘the Anglo-American system’ in contrast to corporate governance frameworks derived from different corporate structures elsewhere in the world. This masks some inherent differences, historical and cultural as well as regulatory, which deserve attention by policy makers.

The next chapter reviews the findings of the study, outlines the questions prompted by the analysis of the data and identifies areas for consideration and further research by policy makers and regulators.

7 SUMMARY AND CONCLUSIONS

Introduction

In recent years there have been increasing demands in the UK and the US for disclosures on internal control by corporate boards. The objective of this study is to seek an improved understanding of the rationale for these demands and of the responses of disclosers and their audiences to the impact of the disclosure requirements which have been established in consequence. This is achieved by close examination of responses to contemporaneous public consultations in these countries on specific components of the regulatory framework in each country. The study presents a snapshot of a small part of the corporate governance landscape in each country in 2004/5, through the eyes of those who responded to the consultations.

A number of questions and areas for further investigation arise from consideration of these differences as revealed by the analysis of the data and these are discussed in this chapter. The limitations of the study are also outlined.

Questions for consideration

The role and context of regulation

While the study compares like with like in terms of exploring perspectives on the issue of internal control disclosure, it is important to recognise that the disclosure solution itself stems from different political contexts and motivations. In the US, corporate governance developments from the Foreign Corrupt Practices Act (FCPA) onwards have focused

on the detection of fraudulent reporting and on ensuring accountability through regulatory compliance. In the UK, while significantly influenced by the US approach, particularly with regard to the establishment of audit committees, the focus has been on requiring company boards to adopt accepted best practice; this could be described as ensuring accountability through norms of behaviour. In the US, Sarbanes-Oxley (SOX) legislation is a reactive response to perceived limitations in corporate governance and reporting highlighted by financial scandals. In the UK, internal control disclosure is seen as an important defence against the imposition of more prescriptive regulation.

Similarly, the two countries differ in the connection to, and impact on, existing regulation. In the US it became necessary to adapt the existing auditing standard AS2 in order to accommodate the consequences of SOX. In the UK, the Turnbull guidance was closely connected to the development of the Combined Code and represented an elaboration of the implementation of the Code with no conflict with existing provision.

The contrasts identified in the previous chapter arise in large part from the differing contexts of the two consultations and clearly show that, even though internal control disclosure is viewed as a useful corporate governance mechanism in both countries, the effect of disclosure requirements sited in two differing regulatory approaches is potentially very different.

Research to date has focused predominantly on an analysis of the disclosures themselves but the concern among Turnbull respondents about the lack of substantial information provided suggests that it may be more fruitful to focus instead on the process by which disclosure comes about, rather than the outcome in terms of content. **If internal control disclosure is aimed at promoting accountability through behavioural norms, as in the UK, rather than legislative compliance as in the US, what effect does this have within organisations?**

This question is also related to the concerns of respondents about changing relationships consequent on increased disclosure requirements, in particular that between companies and their auditors, both internal and external. The audit committee is central to the management of both audit roles but neither set of respondents had much to say about this. **To what extent have increased internal control disclosure requirements affected the audit committee role?**

Interpretation and understanding of terms

This study has contributed to an understanding of the 'reactive evolution' (Heier *et al.*, 2005) of internal control. It highlights the importance of the interpretation of definitions and demonstrates that the evolving nature of linguistic presentations has implications for rules about disclosure.

While there may be advantages to defining internal control in terms of risk management, as has happened in the UK, the relationship between the two remains ambiguous and this may have practical implications. The Hampel report argued that the regulation of the downside of risk through internal control was achieved at the expense of the recognition of the positive view of risk which underpins enterprise. The later Turnbull redefinition of internal control as risk management emphasises links to strategy formulation and characterises internal control as a support for enterprise (Page and Spira, 2004). The UK propensity to link internal control with risk management provides a broader holistic appreciation of the role of internal control in achieving business objectives. In contrast, the US approach of compliance with narrowly defined prescription, coupled with the significant impact on companies of compliance costs, may lead to a loss of perspective which could potentially inhibit achievement of business objectives as well as hindering the development of a successful regulatory environment.

The expression 'high level' features in the Turnbull consultation and responses but its meaning is unclear: does it mean nothing more than

a broad interpretation of internal control as against a narrower one? Or does it imply some kind of over-arching understanding that remains implicit rather than clearly articulated?

Recommendations among SOX section 404 respondents for a shift towards a 'principles-based' approach suggest that understandings of the meaning of 'principles-based' may differ, among regulators, disclosers and their audiences as well as internationally. **If definitions and interpretations vary between countries often viewed as having a common approach, what are the implications for international convergence?**

Costs

This study has identified a significant difference between the UK and US regimes with regard to concerns about the cost of complying with disclosure requirements. While this is a major concern for US respondents, it receives comparatively little attention in the UK context. In the light of the ongoing 'rules versus principles' debate this difference seems worthy of research: **is a principles-based system less costly than a rules-based system in terms of regulatory impact?**

Respondents to the US consultation focused on the costs of complying with legislative requirements but opportunity costs are a further issue to be considered. When the report of the Cadbury Committee was published in 1992 some concern was expressed by commentators about the possible negative impact on entrepreneurial activity of an increasing focus on compliance. This concern was reinforced by the subsequent Hampel report:

The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past few years. We would wish to see the balance corrected. ..the emphasis on

accountability has tended to obscure a board's first responsibility – to enhance the prosperity of the business over time. (Hampel Committee, 1998, p.7)

The Hampel Committee cited no evidence to support this assertion and the question remains unanswered: **to what extent do increased disclosure requirements influence the risk appetite of corporate boards?**

The role of consultation

The consultation processes which generated the data examined in this study were rather different and these differences have been identified in previous chapters. Consultation on the development of corporate governance regulation is becoming more frequent in the UK and in both countries the published consultation responses provide a source of readily accessible research data which has not been widely explored and could usefully complement analyses of disclosure outcomes. However, the influence of consultation responses on policy makers and regulators remains unclear.

The publication of consultation responses online is a welcome development but, in seeking increased transparency in company disclosures, regulators themselves need to be more transparent about the process of policy development. If consultations of the type studied here are to be more than a cosmetic exercise, we would urge regulatory bodies to publish not only consultation responses but further details of the process of developing regulatory policy, showing clearly how these responses have influenced their deliberations. A transparent rationale for disclosure requirements, and for other forms of regulation, would engender greater confidence in the process and its outcomes.

Limitations

As noted in chapter three, the data as a whole is a self-selected sample, comprising the opinions of those individuals and groups with particular concerns about the issues. However, the sample drawn from that population has been deliberately designed to reflect the broad range of respondent positions. Limited inferences about motivation may be made from considering the position of respondents but the study does not aim to develop generalisations about the views of different groups, nor to assess the influence of the responses on subsequent events.

It is important to recognise that this interpretation of the data may be culturally biased in that it is based on the understanding and experience of researchers based in the UK. US researchers might provide an alternative perspective. As the data is in the public domain, this presents an opportunity for further research.

The study represents a snapshot of part of the process of corporate governance regulatory development in the UK and the US at a specific point in time. This process is dynamic and ongoing and, while the historical evolution of the concept of internal control in each country is outlined, the study does not explore subsequent developments. Nor does it explore parallel developments in the EU. A further study could incorporate the published responses to the FEE Risk Management and Internal Control in the EU Discussion Paper published in March 2005. These appear broadly similar in nature to those received by the Turnbull Review Group although a detailed analysis has not been conducted.

Summary

Corporate governance develops dynamically as illustrated by the changing definition and scope of internal control outlined in this study. The landscape is influenced by many factors which vary between countries. While notions of best practice may have some commonality, convergence of standards remains unlikely given the differing approaches

to regulation highlighted here. Time and place matter, as do economic environments and the influence of pressure groups.

Regulations are embedded in national, historical and cultural contexts. Even where broad similarity is assumed, underlying differences with regard to definition, interpretation and the process and impact of regulatory development may be significant. If regulators and policy makers do not take account of these differences, regulatory development, whether based on enforced legislative compliance or the adoption of preferred behavioural norms via voluntary codes, may be ineffective.

R

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A PPENDIX A

Disclosure Requirements: Sarbanes-Oxley Section 404

The full text of section 404 is as follows:

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

- (a) **RULES REQUIRED** - The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 USC. 78m or 78o(d)) to contain an internal control report, which shall:
 - (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

- (b) **INTERNAL CONTROL EVALUATION AND REPORTING** - With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance

with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

SEC Rules relating to the implementation of section 404 may be found on the SEC website www.sec.gov

Useful links within that site are:

<http://www.sec.gov/spotlight/sarbanes-oxley.htm>

<http://www.sec.gov/rules/proposed/33-8138.htm>

A PPENDIX B

Disclosure Requirements: Turnbull guidance

The full text of the revised Turnbull guidance on Internal Control (2005) can be found at the web site of the Financial Reporting Council <http://www.frc.org.uk/corporate/internalcontrol.cfm>

The full text of the section of the 1999 Turnbull guidance on *The board's Internal Statement of Internal Control* (Internal Control Working Party, 1999, p.11, para 35-41) is as follows:

THE BOARD'S STATEMENT ON INTERNAL CONTROL

35. In its narrative statement of how the company has applied Code principle D.2, the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.
36. The board may wish to provide additional information in the annual report and accounts to assist understanding of the company's risk management processes and system of internal control.
37. The disclosures relating to the application of principle D.2 should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its

effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

38. In relation to Code provision D.2.1, the board should summarise the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.
39. Where a board cannot make one or more of the disclosures in paragraphs 35 and 38, it should state this fact and provide an explanation. The Listing Rules require the board to disclose if it has failed to conduct a review of the effectiveness of the company's system of internal control.
40. The board should ensure that its disclosures provide meaningful, high-level information and do not give a misleading impression.
41. Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed.

A PPENDIX C

Turnbull Review Group: Outline Summary of Responses by Question

<p>Question 1:</p> <p>Has the Turnbull guidance succeeded in its objectives?</p>	<p>Responses are in the affirmative, although usually with caveats.</p> <p>Positive aspects of question responses included:</p> <ul style="list-style-type: none">• Use of a principles-based approach ensures enduring relevance.• The guidance has raised awareness of best practice and of the importance of risk management.• The reach of the guidance has extended beyond its original target of listed companies to all sectors and sizes of organisation.• All aspects of the guidance remain fully relevant. <p>Caveats included:</p> <ul style="list-style-type: none">• The Turnbull approach may not have become part of corporate culture in some cases.• Any genuine alteration in business practice may be minor; e.g. directors may not have been very diligent about annual reviews of effectiveness.• Adaptable, flexible and non-prescriptive approach is appreciated by companies.
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<p>Question 2:</p> <p>Are companies behaving differently as a result of the guidance? In particular, has the guidance had an impact on:</p> <ul style="list-style-type: none"> • The understanding of risks and controls (a) at board level; and (b) more widely within companies and groups? • The way boards have approached business risk and strategy? • The risk appetite of the board? • Improving the quality of risk management and internal control within companies? 	<p>Positive impacts included:</p> <ul style="list-style-type: none"> • An increased awareness and better understanding of risk and controls. • Introduction of more formal approaches to risk management. • No change to risk appetite. <p>Less positive aspects included:</p> <ul style="list-style-type: none"> • Improved understanding of risk and controls has not necessarily trickled down from board level to the rest of the organisation. • The continuing absence of meaningful disclosure about risk. • Boards have not formally articulated their understanding of the term ‘risk appetite’.
<p>Question 3:</p> <p>What difficulties, if any, have organisations had in implementing the Turnbull guidance?</p>	<p>Commonly, companies reported few, if any, difficulties in implementing the guidance. Difficulties identified included:</p> <ul style="list-style-type: none"> • Limited availability of sufficient time to identify risks. • Obtaining ‘buy in’ to risk management at all levels of the organisation. • Determining the definition and measurement of risk appetite.

<p>Question 4:</p> <p>Should the guidance continue to retain a high level and risk based approach to internal control rather than move to a more prescriptive approach?</p>	<p>There was a strong feeling amongst most respondents that the high-level risk based approach was appropriate to the UK environment. Its flexibility and adaptability were seen as major strengths.</p>
<p>Question 5:</p> <p>Should the guidance continue to cover all controls?</p>	<p>Respondents generally considered that all categories of control should continue to be covered, and that it would be inappropriate to limit the scope of the guidance to, for example, internal financial controls.</p>
<p>Question 6:</p> <p>Are there any parts of the guidance on internal control that are (a) out of date or now unnecessary?; (b) unclear?; or (c) lacking in sufficient detail? If so, please identify them.</p>	<p>The continuing relevance of the guidance was confirmed by most respondents. Concerns were expressed about the increasing costs and consumption of time if more detailed provision were to be required. The need for greater guidance was identified by some individual respondents in respect of, for example:</p> <ul style="list-style-type: none"> • Corporate social responsibility issues; and • Glossary of terms including definitions of risk management, risk appetite and material control aspects.

<p>Question 7:</p> <p>If additions are needed to the guidance, what form should they take, what should they cover, and why would they be useful?</p>	<p>Many respondents noted the risk that any more questions, indicators or examples would drive the process further towards a checklist mentality. However, suggestions for additions included:</p> <ul style="list-style-type: none"> • Definitions of some basic risk terminology. • More examples of the types of risks boards should consider. • Some specific guidance on an appropriate form of disclosure about the risk review process. • The guidance should incorporate the concept of ‘upside risk’.
<p>Question 8:</p> <p>Do you have any other suggestions for changes to the guidance that are not covered by the questions above?</p>	<p>Examples included:</p> <ul style="list-style-type: none"> • Turnbull should be expanded to address any new EU requirements. • Current guidance could give more help to directors in dealing with problems. To avoid excessively lengthy guidance, cross references could be made to other relevant sources.
<p>Question 9:</p> <p>How useful to investors and companies are the existing disclosures on internal control? What value is placed on such disclosures by investors when making investment decisions?</p>	<p>Existing disclosures were typically described as ‘bland and anodyne’, ‘boilerplate’ and ‘generic’. They were seen by respondents as providing little value for investors in respect of decision-making although a few respondents noted that they could nevertheless be of value for the purposes of accountability and assessing directors’ stewardship.</p>

<p>Question 10:</p> <p>Would a different or extended form of disclosure facilitate better decision-making. If so, how?</p>	<p>Respondents were commenting at a time when it was expected that the Operating and Financial Review (OFR) would become compulsory. Several commented that any need for extended disclosure would be covered by the OFR. Other comments included:</p> <ul style="list-style-type: none"> • More disclosure would facilitate better decision-making only if it were of high quality. • Any prescribed form of reporting would lead only to further boilerplate wording. • The influence of Sarbanes-Oxley disclosures could change perceptions of the value of certain types of disclosure.
<p>Question 11:</p> <p>What distinctions or linkages should be made between the business risk-related disclosures to be made in the Operating and Financial Review and the disclosures made as a result of the Turnbull guidance?</p>	<p>Respondents were commenting at a time when it was expected that the Operating and Financial Review (OFR) would become compulsory. Broadly, two views were expressed by respondents:</p> <ul style="list-style-type: none"> • The Turnbull and OFR disclosures should be kept separate because they deal with different aspects of risk. • It is important to avoid proliferation of disclosures and it would be preferable to integrate Turnbull and OFR disclosures.

<p>Question 12:</p> <p>What are the advantages and disadvantages of turning the board's private assessment of effectiveness into a public statement of their conclusion on effectiveness?</p>	<p>Cited advantages included:</p> <ul style="list-style-type: none"> • Would add rigour to the assessment of effectiveness. • A public statement of effectiveness would assist with the efficiency of capital allocation. • Increased transparency and accountability. <p>Cited disadvantages included:</p> <ul style="list-style-type: none"> • Significant litigation risk. • Risk of creating a new expectations gap between companies' understanding and investors' understanding of the effectiveness statement. • Likely to significantly increase costs, especially if external verification were required. • Any requirement for such a disclosure is likely to be reduced to a meaningless 'boilerplate' statement.
<p>Question 13:</p> <p>Would boards and investors wish to see additional disclosures on the outcome of the board's review of effectiveness and actions taken following that review? If so, what information would be appropriate?</p>	<p>Corporate respondents tended to the view that any such additional disclosures would be unhelpful. Some investors, however, commented that additional disclosures could provide shareholders with more confidence in a company's control environment.</p>

<p>Question 14:</p> <p>What benefit does the existing work performed by external auditors on internal control, and the subsequent dialogue with the board, provide to:</p> <p>(a) the board of a company?; (b) investors?</p>	<p>Some respondents felt that benefits were provided:</p> <ul style="list-style-type: none"> • Investors may gain comfort from the fact that auditors are looking at the area. • Board and investors are provided with a level of comfort about the integrity of the financial statements. • The board receives valuable information about internal control from the auditors but this may not be visible to investors. • Auditor presence tends to ensure that management attention is directed towards internal controls. <p>Others saw few or no benefits:</p> <ul style="list-style-type: none"> • The current role of auditors in this respect was seen as ‘woefully inadequate’. • Audit work on internal controls provide few benefits.
<p>Question 15:</p> <p>What are the advantages and disadvantages of extending the external auditors’ remit beyond the existing requirements? If you consider that any change should be made to the existing remit, what might this be and why?</p>	<p>Most respondents saw mainly disadvantages to the extension of the auditors’ remit. Points made included the following:</p> <ul style="list-style-type: none"> • The experience of implementing Sarbanes-Oxley section 404 suggests that fees would increase considerably if the remit were extended. • Benefits would have to outweigh the very considerable cost involved in extending the remit. • It would not be feasible to extend the remit without a change in the auditor liability regime.

<p>Question 16:</p> <p>What impact, if any, might an extended role for the external auditor have on the relationship and dialogue between the external auditor and the board and its committees?</p>	<p>Some respondents felt there would be no significant change to the relationship and dialogue, because internal controls are already discussed. Others saw potential changes:</p> <ul style="list-style-type: none"> • There might be a risk to auditor independence, especially if auditor recommendations were adopted as managerial decisions. • Communications between board and auditors might become more formal. • The dialogue between board and auditors might increase.
<p>Question 17:</p> <p>Are there any other matters that should be brought to the attention of the Review Group?</p>	<p>Responses to this question included the following matters, requests and recommendations:</p> <ul style="list-style-type: none"> • Any revised guidance should discourage ‘boilerplate’ disclosure. • Request that a significant period should be allowed to lapse before the next review. • Companies should maintain up-to-date descriptions of their financial systems. • If proposals for change are investigated, the Review Group should commission quality research into costs and benefits. • Cost effectiveness should be carefully considered before any changes are made. • There should be greater clarity about sanctions applicable to boards of companies that do not have sound internal control.

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BOUT THE AUTHORS

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Reporting on Internal Control in the UK and the US: Insights from the Turnbull and Sarbanes-Oxley Consultations

The changes that were brought about to internal control reporting by the Sarbanes-Oxley Act and the Turnbull guidance provide a real opportunity to look at the implications of these requirements and the process of policy development.

This report reviews the two different approaches to internal control reporting in the US and UK, both in terms of definition and regulatory approach, before contrasting the responses of respondents to the Sarbanes-Oxley section 404 consultation and the Turnbull review consultation in 2004/5. These contrasting views provide a novel insight into the role of consultation in regulatory change in two important regimes.

The report also demonstrates that, despite the perception of an 'Anglo-American' approach to corporate governance, there are distinct differences in approach to internal control reporting in the UK and US.

The report highlights significant issues for further research including: the impact of internal control reporting on organisations and audit committees; the implications for international convergence of different definitions of internal control; a cost comparison between a principles-based and a rules-based system for internal control disclosure; and the impact of disclosure requirements on the risk appetite of boards.

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