INTERNAL CONTROL AND FINANCIAL REPORTING

Guidance for directors
of listed companies
registered in the UK

December 1994

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AND
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GUIDANCE FOR DIRECTORS
OF LISTED COMPANIES
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FOREWORD

from the Committee on the Financial Aspects of Corporate Governance ('Cadbury Committee')

The Committee welcomes the guidelines published by the Working Group on Internal Control and appreciates the work involved in giving effect to the intentions of paragraph 4.5 of the Code of Best Practice, in terms which make it clear to boards of directors of listed companies what is expected of them.

The aim of paragraph 4.5 of the Code is to ensure both that there is an appropriate control system in place and that it is being applied effectively. Failures in systems of internal financial control were one of the causes of the setting up of the Committee. The Committee believes that the Working Group's guidelines are consistent with the spirit of paragraph 4.5, including the reporting requirements as to responsibility and the descriptions of key procedures designed to provide effective internal financial control.

Directors may also wish to state their opinion on the effectiveness of their system of internal financial control. Such statements will be helpful as a means of working towards full implementation of this section of the Code.

In the meantime, compliance with the guidance issued by the Working Group will be regarded as constituting compliance with paragraph 4.5 of the Code. The Committee's successor body will put in hand a review of the working of the Code when it takes over in June 1995 and, in doing so, will have the benefit of practical experience of the way in which the guidance on internal control is being implemented.

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INTRODUCTION

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1. The report of the Cadbury Committee recognised that *'an effective internal control system is an essential part of the efficient management of a company'* and paragraph 4.5 of the Code requires that:

   'The directors should report on the effectiveness of the company's system of internal control.'

2. Note 13 to the Code notes that companies will not be able to comply with paragraph 4.5 until the necessary guidance for companies has been developed. The report recommended that:

   'the accountancy profession, in conjunction with representatives of preparers of accounts, should take the lead in:

   (a) developing a set of criteria for assessing effectiveness;

   (b) developing guidance for companies on the form in which directors should report; and

   (c) developing guidance for auditors on relevant audit procedures and the form in which auditors should report.'.

   In response to this recommendation, a working group was set up to produce proposals on (a) and (b) above. This guidance is the result. The Auditing Practices Board was asked to address (c).

3. The guidance is a supplement to the Code itself and is therefore aimed primarily at listed companies incorporated in the United Kingdom, which include companies registered on the Unlisted Securities Market (USM). However, the principles described are relevant to all business enterprises.

4. The guidance should be regarded as standard for accounting periods beginning on or after 1st January 1995 but companies may, as a transitional measure, report on the systems in place from 1st July 1995 to the end of their first financial year beginning on or after 1st January 1995.

STATEMENT OF PRINCIPLES

1. The board is ultimately responsible for the system of internal control used in the company or group and for monitoring its effectiveness. It will normally delegate the detailed design and operation of the system and some of the monitoring procedures.

2. *'Internal control'* can be defined as:

   'The whole system of controls, financial and otherwise, established in order to provide reasonable assurance of:

   (a) effective and efficient operations;

   (b) internal financial control; and

   (c) compliance with laws and regulations.'.

   The Cadbury Code is concerned with the financial aspects of corporate governance and thus principally with *'internal financial control'*. This is defined as:

   '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.'.

   In principle, the definition of internal financial control excludes efficiency, value for money, and legal and regulatory compliance issues. In practice, however, consideration of the effectiveness of internal financial control may need to include the consideration of certain operational and compliance controls which address activities which have or could have a potentially material financial impact on the true and fair view presented in the financial statements.

3. The *'effectiveness'* of internal financial control should always be interpreted in terms of its appropriateness to the business concerned and is therefore a matter for judgement. Internal control cannot provide certainty against material errors, losses or fraud; it can only provide *'reasonable assurance'*.

4. The extent and formality of individual internal financial controls should have regard to the materiality of the financial risks incurred, the likelihood of such risks crystallising and cost/benefit.

5. In assessing the effectiveness of a system, attention should be directed to whether the material risks have been identified and have been given the requisite attention, as well as to the nature of the action taken.

6. The need for formal systems and monitoring is likely to increase with the size of and public interest in the enterprise concerned.

7. The form of the statement which the directors should make is not prescribed and it may be included within a statement on corporate governance or directors' responsibilities, or within the Directors' Report or the Operating and Financial Review. Readers will normally, however, expect to see the statement within the statement on corporate governance, which should therefore include cross references to components included elsewhere in the annual report.

8. The statement should contain as a minimum:

   (a) acknowledgement by the directors that they are responsible for the company's system of internal financial control;

   (b) explanation that such a system can provide only reasonable and not absolute assurance against material misstatement or loss;

   (c) description of the key procedures that the directors have established and which are designed to provide effective internal financial control; and

   (d) confirmation that the directors (or a board committee) have reviewed the effectiveness of the system of internal financial control.

   Directors may also wish to state their opinion on the effectiveness of their system of internal financial control. This would help to establish the way in which such statements can most usefully be made.

9. The directors' statement should cover the period of the financial statements and should also take account of material developments between the balance sheet date and the date upon which the financial statements are signed.

10. The directors of a parent company preparing group financial statements should make their statement regarding internal financial control in respect of the group as a whole.

11. The description of the key procedures that the directors have established should address the specific high level procedures used by the company/group and how the directors review the effectiveness of the system of internal financial control. It should have regard to the criteria set out later in this document. These may be summarised as follows:

(a) the steps taken to ensure an appropriate control environment (eg clear management responsibilities in relation to internal financial control, unambiguous responses to control failures);

(b) the process used to identify major business risks (including optionally a brief explanation of the major financial risks identified) and to evaluate their financial implications (eg board or committee review of the risk implications of new treasury products);

(c) the major information systems that are in place (eg annual budgeting, monthly reporting and comparison with budgets and forecasts);

(d) the main control procedures which address the financial implications of the major business risks (eg authorisation limits, segregation of duties);

(e) the monitoring system the board uses to check that the system is operating effectively (eg the role of the audit committee, management reviews, internal audit function and/or reports from independent accountants).

The description should avoid excessive detail, recognising that the way in which major business risks are identified and evaluated, the principles that are applied and the high level monitoring procedures are more relevant in the context of public reporting than descriptions of the accounting system and its related low level controls.

12. Where weaknesses in internal financial control have resulted in material losses, contingencies or uncertainties which require disclosure in the financial statements or in the auditors' report, the directors should:

(a) describe what corrective action has been taken or is intended to be taken; or

(b) explain why no changes are considered necessary.

13. Directors must always ensure that their statement does not give a misleading impression.

14. Directors may wish to and are encouraged to extend the scope of their statement to cover their responsibility for the wider aspects of internal control (rather than just internal financial control), in which case their statement should be set out in a way which allows shareholders to understand the scope of their remarks.

CRITERIA FOR ASSESSING EFFECTIVENESS

In considering the effectiveness of internal financial control, directors should have regard to the criteria set out below, recognising that these criteria should be interpreted in accordance with the statement of principles. The framework for these criteria is similar to that set out in *'Internal control—integrated framework'*, a report published in the USA by the Committee of Sponsoring Organisations of the Treadway Commission ('COSO').

1. **Control environment**
   - A commitment by directors, management and employees to competence and integrity (eg leadership by example, employment criteria).
   - Communication of ethical values and control consciousness to managers and employees (eg through written codes of conduct, formal standards of discipline, performance appraisal).
   - An appropriate organisational structure within which business can be planned, executed, controlled and monitored to achieve the company's/group's objectives.
   - Appropriate delegation of authority with accountability which has regard to acceptable levels of risk.
   - A professional approach to financial reporting which complies with generally accepted accounting practice.

2. **Identification and evaluation of risks and control objectives**
   - Identification of key business risks in a timely manner.
   - Consideration of the likelihood of risks crystallising and the significance of the consequent financial impact on the business.
   - Establishment of priorities for the allocation of resources available for control and the setting and communicating of clear control objectives.

3. **Information and communication**
   - Performance indicators which allow management to monitor the key business and financial activities and risks, and the progress towards financial objectives, and to identify developments which require intervention (eg forecasts and budgets).
   - Information systems which provide ongoing identification and capture of relevant, reliable and up-to-date financial and other information from internal and external sources

(eg monthly management accounts, including earnings, cashflow and balance sheet reporting).

- Systems which communicate relevant information to the right people at the right frequency and time in a format which exposes significant variances from the budgets and forecasts and allows prompt response.

4. **Control procedures**

- Procedures to ensure complete and accurate accounting for financial transactions.
- Appropriate authorisation limits for transactions that reasonably limit the company's/group's exposures.
- Procedures to ensure the reliability of data processing and information reports generated.
- Controls that limit exposure to loss of assets/records or to fraud (eg physical controls, segregation of duties).
- Routine and surprise checks which provide effective supervision of the control activities.
- Procedures to ensure compliance with laws and regulations that have significant financial implications.

5. **Monitoring and corrective action**

- A monitoring process which provides reasonable assurance to the board that there are appropriate control procedures in place for all the company's/group's financially significant business activities and that these procedures are being followed (eg consideration by the board or board committee of reports from management, from an internal audit function or from independent accountants).
- Identification of change in the business and its environment which may require changes to the system of internal financial control.
- Formal procedures for reporting weaknesses and for ensuring appropriate corrective action.
- The provision of adequate support for public statements by the directors on internal control or internal financial control.

APPENDIX A

MEMBERSHIP OF THE WORKING GROUP

The Working Group comprised individuals put forward by The Hundred Group of Finance Directors, the Institute of Chartered Accountants in England and Wales, including its Board for Chartered Accountants in Business, and the Institute of Chartered Accountants of Scotland, who fulfilled the requirement of the Cadbury Committee for *'the accountancy profession in conjunction with representatives of preparers of accounts'* to develop guidance.

Paul Rutteman CBE, BSc(Econ), FCA (Chairman)	Partner, Ernst & Young
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Tony Bingham FCA	Partner, Coopers & Lybrand
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Mike Townsend MA, FCA	Finance Director, Rolls-Royce plc

Support was provided by Richard Chinn MA, FCA of the ICAEW Secretariat.

APPENDIX B

BIBLIOGRAPHY

The guidance attempts to codify existing best practice and, for this reason, draws on what it considers helpful sources in the area. In addition to the Cadbury Report itself, particular reference has been made to:

— *'The auditor's operational guidance—Internal Controls'.* Guidance issued by the Auditing Practices Committee of CCAB. 1980.

— *'Managing business risk'.* A statement issued as guidance on good practice by the Institute of Chartered Accountants in England and Wales. 1990.

— *'Corporate governance—Directors' responsibilities for financial statements'.* Recommendations of a working party established by the Institute of Chartered Accountants of Scotland. 1992.

— *'A framework for internal control'.* A paper for the Law and Parliamentary Committee of the Chartered Institute of Management Accountants. 1992.

— *'Internal control—integrated framework'.* A report published in the USA by the Committee of Sponsoring Organisations of the Treadway Commission ('COSO'), after a five year study involving hundreds of individuals, including corporate executives, legislators, regulators, consultants, auditors and academics. 1992. Three volumes plus an executive summary are available from the Order Department, American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza III, Jersey City, NJ 07311–3881.

— *'Guidance on criteria of control'*—an exposure draft produced by the Canadian Institute of Chartered Accountants. 1994.

In addition to these sources, the first exposure draft of this guidance, issued in October 1993, contained more detailed discussion of the various issues.

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