

19 July 2005

Mr David Devlin
President
FEE

By email to : secretariat@fee.be

Dear Mr Devlin

Risk Management and Internal Control in the EU discussion paper

The Chartered Institute of Management Accountants (CIMA) welcomes the opportunity to comment on this consultation. We believe that it provides a useful overview of all the key issues and raises a number of very pertinent questions that will open minds to the size of the task.

I am sure that you will be aware of the recent publication in the UK of the proposals for updating the Turnbull Guidance. This provides a significant contribution to the debate and CIMA is currently developing its response. As the proposals have only just been published and the consultation period lasts until September, we are not yet in a position to provide our considered views on this more recent development, but our initial reaction is one of satisfaction that the Turnbull Review Group has endorsed the principles-based approach so strongly.

A particular aspect of the internal control debate that we are reviewing in the light of the Turnbull proposals is that of providing effectiveness opinions. Although the European view does not favour requirements for public reports on effectiveness in contrast to US requirements under the Sarbanes-Oxley Act, CIMA's view is that the debate on the merits of effectiveness statements needs to remain open with some consideration of the potential scope for greater convergence between the two approaches.

You may also be interested to be aware of the work that we are doing to develop the CIMA Strategic Scorecard. This provides the means for boards to obtain assurance that the strategic process is operating effectively. A particular area of focus of the scorecard relates to the effective oversight of strategic risks and we believe that this work provides a useful contribution to the risk management debate. A discussion paper on the topic can be found on our website at www.cimaglobal.com in the dedicated Resources area and I should welcome any views that you may have on it.

CIMA looks forward to contributing to this important topic as it develops in future. Please do not hesitate to contact me if there are any issues which require further clarification.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Charles Tilley', is written over a white background.

CHARLES TILLEY
Chief Executive

Att:

RISK MANAGEMENT AND INTERNAL CONTROL IN THE EU – FEE DISCUSSION PAPER

General comments

CIMA welcomes FEE's discussion paper as a valuable contribution to the debate on risk management and internal control. The analysis is very clear and the paper provides a useful overview of recent developments in this area. It also raises a number of very pertinent questions that will open minds to the size of the task. This is clearly an evolving area and it will be necessary to develop many aspects of the paper in more depth over time. However, this discussion paper is an excellent starting point and CIMA looks forward to contributing to further thinking on this subject in the future.

A specific area which we feel could have been developed further is the roles and responsibilities of the key players in risk management and internal control. While there is a section dedicated to the role of the external auditor (section 6), the discussion could have been enhanced by considering the crucial role to be played by the professional accountant in business in risk management and internal control. This would include some consideration of the role of internal audit.

We also feel that the paper would have been enhanced with additional background on what risk management actually is, including some brief background on identifying and analysing risks and typical risk responses (avoidance, reduction, retention and transfer).

Since the publication of this discussion paper, there has been a significant development in the UK with the recent publication of the proposals for updating the Turnbull Guidance. CIMA is currently considering its response to the proposals, but we believe that the decision to endorse the current guidance and recommend only limited changes to bring it up to date will have a significant impact on the European debate as a whole. CIMA's initial reaction is one of satisfaction that the principles-based approach has been endorsed so strongly.

Specific questions

1. Do you agree with FEE that there is a need to promote discussion and evidence gathering to encourage coordination and convergence of the development of risk management and internal control at EU level? If not, please explain.

Yes – it is important to gain a shared understanding of what risk management is. This is because perceptions of risk may vary according to the particular context, for example, companies in different countries may have different views on what risks are important, the appropriate risk appetite and the optimum way of managing the risks. There may also be different views as to what constitutes effectiveness of risk management. It is also useful to share understanding on the extent to which risk management is seen as both offering opportunities to build shareholder value as well as minimising the impact of adverse events.

In the UK, the development of policy in risk management and internal control has been very much driven by the emergence of best practice in major companies and other large organisations such as the National Health Service. In an increasingly global corporate environment, the sharing of best practice across borders can only benefit business and ensure that any regulations support and reinforce such best practice.

2. Do you consider it appropriate for public policy on risk management and internal control in the EU to focus on listed entities and the needs of their shareholders? Alternatively, do you think that there is a pressing need to deal with issues relevant to a wider range of entities and stakeholders? If so, please explain.

Yes – this is for the simple reason that the large listed entities tend to have some of the most substantial risks as well as a diverse shareholder base. UK experience has been that, in any case, best practice codes have often been adopted by public sector organisations, for example, but suitably tailored to take account of their specific circumstances. So best practice in risk management and internal control has translated well across sectors.

In terms of dealing with issues relevant to a wider range of stakeholders, we would apply the concept of “enlightened shareholder value” which is to be enshrined in UK company law once it has progressed through Parliament. Basically, this states that the primary goal for boards should be the success of the company for the benefit of its shareholders, but that to achieve this goal, boards need to give consideration to wider stakeholder needs. This concept applies particularly well to risk management where, for example, a major risk for many major companies is loss of reputation resulting from inadequate attention to customers. We would argue that it is not possible to implement effective risk management and internal control without dealing with issues that are relevant to a wider range of stakeholders.

3. Do you agree with FEE that the case for introducing any regulation related to risk management and internal control should have regard to: the business case for risk management; the advantages of principles-based requirements; the distinctive features of listed companies; the primacy of those charged with governance; and reasonable liability? If not, please provide details.

Yes – these are very robust principles that should underpin the case for any regulation relating to risk management and internal control. CIMA endorses them all without reservation.

4. Are there overriding principles additional to those identified by FEE in Sections 3.1 to 3.5 that are relevant to risk management and internal control? If so, please explain.

The case for greater accountability leading to improved market functioning such as more efficient capital markets (and hence reduced cost of capital) appears to have been overlooked. It is important to ensure confidence and credibility in investor markets. The IFAC report ‘Rebuilding public confidence in financial reporting’ which was published in 2003 and is available on IFAC’s website (www.ifac.org) provides useful discussion on these issues. In addition, the OECD principles on corporate governance also include valuable background on the macroeconomic reasons underpinning good corporate governance. This additional principle could be regarded as ‘the market case for risk management’.

5. Is the matrix for analysis presented in Figure 1 in Section 4.1 clear and useful? If not, please explain why not.

Yes – the matrix is very clear and useful. In our view, it is one of the strengths of the discussion paper in that it provides an excellent framework for discussion and for conveying the need for an evolutionary approach to policy development in this area.

6. Is there any need to develop an EU framework for risk management and internal control? If so, how would you address the concerns about resources and benefits identified by FEE in Section 4.2?

We would agree that there is no need to develop an additional framework in addition to the COSO, CoCo and Turnbull frameworks.

7. Do you agree with FEE’s disclosure principles for risk management and internal control set out in Section 4.3? If not, why not and are there additional factors that should be considered?

Yes – we assume that the disclosure of specific risks refers to those risks where material control weaknesses have been identified rather than a general statement as to management’s approach to specific major risks.

8. Do you agree with FEE’s proposal that there should be a basic EU requirement for all companies to maintain accounting records that support information for published financial statements? If not, why not?

Yes

9. Do high-level criteria need to be developed to promote meaningful descriptions of internal control and risk management as envisaged by the proposal to amend the Fourth and Seventh Directives? If so, who should develop the criteria and if not, why not?

It would be useful to have such high-level criteria. At this stage, it is probably more realistic to leave the development of such criteria to individual Member States and promote convergence via the EU Corporate Governance Forum. This is very much an area under development as evidenced by the current review of the Turnbull Guidance and the recent publication of ASB Reporting Standard: Operating and Financial Review in the UK.

10. What role should regulatory requirements play in promoting improvement in risk management and internal control?

The key role to be played by regulatory requirements is to support and reinforce current and emerging best practice. In addition, they can support and facilitate the development of common standards of disclosure.

11. Do you agree with FEE’s identification of the issues for consideration by listed companies and regulators set out in Section 5.5? Are there any other matters which should be dealt with?

CIMA endorses the issues identified. As indicated earlier, the matrix used throughout the paper helps to support the discussion in a clear and systematic way.

We would agree that, in improving risk management and control, companies should follow an evolutionary approach over a number of years. However, it would be helpful to have some indication of the broad timescales envisaged to tackle each stage of the process.

12. What views do you have on the issues for consideration discussed in Section 5.5?

Issues related to managing risks – it would have been helpful here to use the term ‘enterprise risk management’ and to re-emphasise the business case for risk management.

Issues related to disclosure – a key issue here is avoiding a situation where concerns about liability and commercial sensitivity lead to disclosure that is bland and meaningless.

Issues related to disclosure of effectiveness conclusions - CIMA has previously expressed the view that public reporting on effectiveness is of doubtful value due to the difficulty of defining “effectiveness” precisely. However, the debate has since moved forward, particularly with the introduction of the Sarbanes-Oxley Act. Our initial reaction to the discussion paper was therefore to question FEE’s conclusion of not being convinced as to the usefulness of an effectiveness statement – while CIMA also welcomed the fact that the European Commission had not rushed to implement an EU equivalent of Section 404 of the Sarbanes-Oxley Act (SOX), we were minded to remain open as to the merits of an

effectiveness statement. Indeed, we noted that the discussion in section 5.5.4 reflected a more neutral approach in suggesting that a phased implementation might be considered and that it might only be possible to issue effectiveness opinions in relation to financial reporting rather than the full range of risks (as is the case under SOX). In theory, CIMA believed that it would be preferable for boards to report on effectiveness, but there were a number of practical issues to surmount. The general principle should be to provide maximum assurance for shareholders in the form of useful information with minimum bureaucracy and cost.

However, since we formed the above views, we have had the opportunity to see the evidence published by the Turnbull Review Group (TRG) in the UK. CIMA notes that the TRG has decided that it would not be appropriate to make a report on the effectiveness of the internal control system, but instead, is proposing that boards should be required to confirm that necessary action has been taken or is being taken to remedy any significant failings or weaknesses identified from the review of the effectiveness of the internal control system. CIMA is currently in the process of re-considering its views on effectiveness in the light of the TRG's conclusions, but at this stage, it would be fair to say that our reaction to the TRG's proposals as a whole is one of support for the measured, principles-based approach which builds upon the success of the existing Turnbull Guidance. Perhaps, our main conclusion at present is that the effectiveness debate needs to remain open for the time being, particularly in view of the differences between the US and the European approaches, the need to review how SOX works in practice and the need to consider the scope for greater convergence.

13. Do you consider that the current financial statement audit provides adequate assurance to investors in respect of internal controls over financial reporting? Please explain your response.

The financial statement audit provides some assurance, but we would agree that it cannot provide assurance on disclosures of risk management and internal control not given in financial statements or on the effectiveness of risk management and control.

14. Should new disclosures related to risk management and internal control be subject to external assurance? If so, why, and should this be as part of an integrated financial statement audit as in the United States?

Yes – but not as part of an integrated financial statement audit. We believe that the approach adopted in the UK where auditors are required to review nine of the ten objectively verifiable Combined Code provisions relating to accountability and audit (including internal control) is appropriate.

15. What do you see as the principal priorities in the possible development of new forms of assurance related to risk management and internal control?

CIMA endorses FEE's proposals in section 6.6 as constituting the principal priorities in the development of assurance relating to risk management and internal control.

In addition, do you have any other comments on this discussion paper not covered by the specific questions reproduced above?

No