

**AITC**

**Guidance notes for Directors on monitoring internal  
controls and procedures**

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## **Introduction: the responsibilities of directors and their dependence on others**

Directors of investment trusts have the same responsibilities and operate to the same requirements as any listed company. They subscribe to the Combined Code which is part of the Listing Rule requirements of the London Stock Exchange. The Combined Code requires companies to “maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets”. The Combined Code is clear that reviewing the effectiveness of internal control is the responsibility of the board of directors. Investment trusts usually have boards of non-executive directors. They will not have the time, or the remuneration, to immerse themselves in detail. An approach has to be devised to enable them to assess the risk of unintentional or deliberate misstatements. Guidance on what is expected of directors of listed companies was produced in September 1999 by the ICAEW<sup>1</sup> and has been accepted by the London Stock Exchange as providing compliance with the Combined Code. That guidance is known as the “Turnbull Report”.

This guidance note supplements that report and is issued for directors of investment trusts to assist them in their responsibility for keeping internal controls under review by addressing issues arising from the particular characteristics of investment trusts.

Directors of investment companies not listed in London may wish to adopt similar guidance.

Because investment trusts do not usually have any executive management, even where the board includes a representative from the investment manager, the board of a trust is wholly dependent on external service providers for the execution of its affairs. Often the predominant provider is the investment management company, which may also provide ancillary services such as administration, accounting, custody, company secretary facilities and marketing support. Alternatively any or all of those services might be contracted for separately and the range of service providers may cover:

- (a) Investment Management
- (b) Administrators for accounting services and administration
- (c) Settlement agents
- (d) Company Secretaries
- (e) Custodians
- (f) Savings Plan Administrators
- (g) Registrars

Because of this extent of delegation, implementing the Combined Code for investment trusts will require a different approach from the general run of companies.

In recent years directors of investment trusts have had the benefit of reviews of the generic internal systems of particular service providers. In the UK these are called FRAG 21 reports (named after a committee which devised them) and in the USA, SAS 70 reports. These reports provide some assurance to all the users of the services of custodians and investment managers. But, whilst they are a helpful contribution to an investment trust board’s compliance with the Combined Code, the

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<sup>1</sup> ICAEW. The Institute of Chartered Accountants in England and Wales

information is not specific to any particular investment trust and it is not straightforward for the board to raise issues with the relevant executives directly.

This guidance note therefore advises directors to set out their own requirements, institute their own process of receiving reports and probe the sort of topics raised in Appendices A and B in order to carry out their duties as directors. The intention of this note is to assist Chairmen of trusts, their audit committees and directors generally to tailor their own approach to reviewing the systems of internal control relevant to their trust.

IMRO (in the “IMRO Reporter” November 1996) looked at how delegators should ensure that delegated functions are being carried out properly. Although the relationship between an investment trust board and its service providers is not the same “delegation” which IMRO was then addressing, the IMRO recommendations are appropriate to this guidance:

- Have a service level agreement in each case;
- “Vet” the delegatee and its compliance arrangements;
- Monitor the delegation by requiring reports and access to the people with responsibility (for example, specify that there should be unrestricted conference with the compliance officer on any matters which might be relevant to the trust);
- Have access, if necessary, to the records

and, of course, take remedial steps as soon as matters go wrong. Consultation Paper 35 (CP35) of the FSA issued in December 1999 looks more widely at the responsibility of senior executive management (and therefore the management of most service providers) to take care that appropriate systems and controls are maintained.

The starting point for reviewing how the trust and its service providers have implemented internal controls is to assemble some basic information, probably in the form of a handbook, and to make sure that the composition of the board includes directors either with experience of, or an interest in, the review of internal controls.

### **Directors’ Guide or Handbook**

Virtually all directors are non-executive and they should be provided with some induction and a “handbook” of basic information which should include a summary of the trust’s strategic objectives and investment policies, its investment profile, its benchmark index, a summary of its agreements with its service providers, investment limits and restrictions, schedules of matters to be decided by the board and committees of the board, authority levels, procedures for directors, statutory and other useful information and a summary of the statutory and fiscal framework for investment trusts. Such a guide is an opportunity to set out any of the additional ways in which returns might be enhanced such as underwriting, purchasing income or participating in opportunities with other funds. It might set out policy on how to treat and value illiquid holdings. This sort of guide is a good place to set out an initial simple summary of the internal controls framework of the key service providers (provided by them, of course) and Appendix A draws on a typical example from a directors’ handbook.

## **Board composition: the importance of experience**

Responsibility for internal controls is the responsibility of all directors and the board cannot wholly delegate its responsibilities. Nevertheless, the onus on those directors who are members of an audit committee is now greater and the board should encourage amongst its independent directors an interest in risk management and internal controls. The directors should nominate one of the board's independent directors to be responsible for leading on internal control issues and that director will probably chair the audit committee. Nevertheless the whole board will still need to give the topics raised in this note proper attention.

## **Service agreements**

Service agreements should specify what reports will be provided on internal controls. The directors might like to consider requiring the investment management company to nominate an executive, for example the client service director, to be responsible to the board for keeping the performance levels under review. The directors should keep all these contracts under review. The terms of these contracts have tended to develop and improve over time and become more performance related.

An incidental but important matter of direct impact for the trust may be the credit worthiness of its principal service providers and, where appropriate, their insurance arrangements.

## **Understanding portfolio performance**

Performance is fundamental to a trust's continuing existence. Responsibility for performance lies partly with the directors who will have helped set the strategy of the trust but mainly with the investment manager. Directors need to understand the trust's performance - even if it is apparently remarkably good! They should be familiar with basic measures of investment performance and attribution analysis against the trust's declared benchmark and be competent to question, appreciate and challenge the decisions and strategy of the manager. They should be alert to some of the distortions caused by concentrations of holdings and alert to transactions with related parties.

The directors should consider whether the analyses which they receive tell them whether the fund manager is actually doing what he/she says he is doing. If the managers receive a performance fee, it may be worth anticipating any issues around the approval of that.

## **Investment trust "risk map"**

A framework of risks (often called a "risk map") is a good idea for a starting point for considering internal controls. A "risk map" is any documented process of thinking through where risk exposure may lie and how that is covered by systems of internal controls. An example of an investment trust risk map and some possible consequent controls is set out in Appendix A. Directors might start the process of assessing risk

by reviewing that sort of analysis. The process can be iterative. The administrators might help start the process by drawing up the first risk map.

By documenting this process the board will clarify its expectations on controls and where delegated responsibilities for them lie. The "risk map" should become the subject of regular review on behalf of and by the Board. The investment manager and other service providers may also find that what they considered to be acceptable, generic processes need to be tailored to meet the needs of particular trusts.

The process will take directors into how each service provider manages risk and its systems of internal control.

### **Service provider's controls**

The board should be able to see where each of the relevant, principal controls lies within its service providers and obtain from the provider's senior management regular positive assurance that those controls have operated efficiently and, where errors have been found, the nature of each error and how it has been rectified.

Although the board cannot audit or inspect in any detail its service providers, in all that it receives and hears it should look for responses and behaviour consistent with:

- Organisations committed to best practice;
- The maintenance of Compliance Manuals and internal performance appraisals;
- Standards of behaviour consistent with the IMRO Conduct of Business Rules - which will effectively be subsumed into the Business Standards section of the FSA Handbook when that is published in 2000 (what will happen is that FSA Rules and Guidance will come into force and IMRO Rules will cease to apply);
- Training and competence requirements which follow the IMRO Training and Competence Sourcebook and monitored requirements for Continuing Professional Education (a requirement of most serious professional bodies);
- "Open" upward reporting;
- Sufficient segregation of duties: this means that no significant process or point of control is handled by one person alone but that there is sufficient, senior, independent review such that any errors, suppression of details, deferment of routines or resolution of problems (such as late reconciliations), misstatements (deliberate or not), breaches of rules or fraud will be identified and investigated;
- Compliance functions which are listened to seriously by their own boards and which have a sense of "answerability" to the investment trust client. (This is to be handled with tact because the strict answerability of compliance is to the Head of Legal and Compliance in the service provider and yet a relationship of mutual respect and communication has to be established with the "client board", in other words the trust);
- Continuous compliance monitoring programmes which respond to changing risk profiles;

- Internal auditors who are taken seriously by their respective boards which in turn recognise a duty of care to the investment trust client;
- Information systems which capture transactions and financial information immediately;
- Routines which are supervised and monitored and which provide daily controls which are observed;
- Accounts preparation routines which are prepared in advance by a competent team: the SORP requires some experience and rushed financial statements often contain errors.

Attention to these considerations sets the climate for service provision. All the directors should have an awareness of good practice (which may require some introductory “show and tell” sessions) and several of the directors, and the Chairman, should have a particular interest in good practice and process.

Directors might wish to find out how far IMRO suggestions and recommendations on compliance culture are used within the investment manager and administrators. For example, do the investment managers either apply the IMRO “Compliance Arrangements Scorecard” or have an internal process which is equivalent? Do they apply something similar to the “Compliance Profiles and Performance Measures” in their internal assessments? ( Or whatever equivalents emerge under the FSA Guidance). How far directors can push their enquiries might depend on the nature of the relationship between the board and its service providers.

It is difficult to write guidance on controls in a way which does not appear prescriptive and which does not become an instant check list. The objective of this guidance is to encourage directors to ask questions. For example it is better to ask how duties are segregated and listen to, and probe, the answer than to note a check list which has the item “ticked” in some way. So whereas the rest of this guidance is set out in a manner which is close to a series of lists, we have suggested some lines of questioning in Appendix B and the FRAG 21 or SAS 70 reports are fruitful sources of follow up questions.

Whatever the approach, directors should expect to find evidence of, and receive reports giving comfort on, assertions made to them about such matters as the following:

## **Control Procedures:**

### **1. Supervision at the Investment Managers:**

- Dealing rules which avoid unfair preference or conflicts of interest;
- Separate validation and confirmation of transactions;
- Segregation of duties between those initiating and those recording transactions;
- Daily portfolio reviews;
- Regular reconciliations of stock to custodian’s records;

- Regular performance reviews against consistent benchmarks;
- Use of attribution analysis;
- Market data pricing validation.

## 2. **Procedures to ensure complete and accurate accounting:**

- Orders, trade execution, authorisation, data processing all segregated;
- Validation of net asset statements;
- Reconciliations of cash, currencies and exchange, securities - including company records to custodian's records, control accounts, movements in book costs and market values and clearance of any outstanding items;
- No doubt about instant availability of information from computer files;
- A constant programme of compliance checks and monitoring routines;
- Formal procedures for reporting weaknesses and significant issues immediately to the board and for following up to ensure and report their timely clearance or resolution.

Any indications of delays in processing may indicate back-office confusion. Any such muddle can be expensive to rectify and damaging to reputations.

## 3. **Investment Administration:**

- Pricing reports;
- Liquidity reports;
- Agreement of net asset statements with the fund manager;
- Dual sourcing of information agreed with the fund manager;
- Corporate action reviews;
- Daily cash and allocation reconciliations;
- Dividend monitoring;
- and, in line with the previous paragraph on service providers controls, training and competence rules to ensure appropriate levels of competence.

#### **4. Internal Audit**

- Regular evaluation of key processes, controls and any system changes for the main functional areas within the service provider;
- Evidence that significant findings go to senior executives, are acted upon in a timely manner and that the internal audit function is well respected within the organisation;
- Evidence that significant matters are also shared with the external auditors.

#### **5. Compliance procedures and review**

There should be a report specific to the investment trust board from senior management at the service provider and drawn from a review of other, more detailed, regular reports on internal compliance at the service providers. That report should be co-ordinated by a board representative from the service provider and include a meeting between the board of the trust (or its audit committee) and a senior person from the service provider.

Reports to directors should demonstrate that:

- all breaches have been considered for their root cause. If that happens then there is less chance that apparently minor breaches will be disregarded when they should have been recognised as indicating a more serious problem;
- all matters raised at regulatory visits which could be of relevance to a trust have been addressed in a timely manner and how they have been addressed;
- there are monthly operating reports to the service provider's board which meets regularly to discuss compliance issues. The trust directors will need the assurance that compliance is taken seriously within the service provider;
- monitoring activity is reviewed and prioritised according to a proper process of risk assessment and the service provider's own board regularly reviews its compliance monitoring arrangements and reports.

#### **Bearing the Onus**

Investment trust directors are not there to bear other people's responsibilities. They should not hesitate to make it clear that they expect their service providers to meet their requirements. Nor should they hesitate to make it clear that they rely on the external auditors to have considered the aspects of risk at financial statement level for investment trusts.

[Improving this guidance note: The investment trust industry is never static. The authors of this note, Hugh Aldous and Mark Phythian-Adams, would welcome comments, improvements and additions at any time and they may be contacted via Ian Sayers, Technical Director at the AITC. ]

## MONITORING INTERNAL CONTROLS

Investment trust boards/audit committees should construct their own aide memoires to assess the effectiveness of internal financial controls. The following suggestions are not exhaustive, nor are they prescriptive, but they are intended to indicate some principal themes of direction and enquiry

### ◆ **Trading**

Agree clear objectives. What is special about this fund?

What is the investment strategy and can it be expressed as performance against benchmark indices?

Review investment limits and restrictions.

Receive regular reports covering transactions, gearing, currency exposure, use of any derivatives hedges or options, revenue forecasts, performance and investment policy.

Commissions: ask for and review ad hoc reports which set out who gets what and why (including the use of soft commissions).

Expenses: any unusual payments to lawyers, advisers, agents, consultants, brokers should be explained immediately.

### ◆ **Internal Controls**

Receive reports at least half-yearly on the systems of internal controls and their effectiveness covering:

- safeguarding of assets;
- accounting and reporting;
- investment management, dealing and treasury;
- legal and compliance;
- complaints;
- and marketing.

Meet with representatives responsible for reviewing key risks and controls and satisfy themselves that those reviews are part of a constant programme.

### ◆ **Key risks**

Review reports against a key risks map which itself should be discussed and developed as knowledge of the trading environment increases.

## KEY RISKS AND CONTROLS FOR INVESTMENT TRUSTS

These are some key risks and some appropriate controls which have been extracted from a typical risk map:

Risks	Key Controls
<p><u>Conflicts of interest within the investment managers</u></p>	<p><u>In house rules on dealing</u>, on clarity of mandates and openness with clients, on dealing (if any) on own account. Rules on allocation and execution, open records of all dealing. Evidence of seniority in, and respect for, the compliance function.</p>
<p><u>Mis-management of the portfolio</u></p>	<p><u>Clear strategy and instructions</u>: regular performance reviews and attribution analysis; shared understanding between the board and the manager as to the distribution of the portfolio.</p> <p><u>Segregation of duties</u> between an overview of fund management, the fund management team, dealing functions and settlement functions.</p> <p><u>Investment limits and restrictions</u> monitored closely and management reports used to monitor activity.</p> <p><u>Allocations</u> to clients are co-terminus with dealing and all transactions are time marked.</p> <p>Allocations pro rata or to a formula agreed with clients except on rare occasions which have to be justified.</p> <p><u>Derivative trades</u> (if any) executed by Central Dealing Desk and checked against the client's investment authority, limits and restrictions before dealing. Exposure monitored daily and reviewed by senior management. All trades reported to client board meetings.</p>
<p><u>Mis-appropriation of client assets</u></p>	<p><u>Stock reports</u> produced by external custodians are <u>reconciled</u> to in-house stock records regularly and independently reviewed.</p> <p><u>Stock held in an identified manner</u> which attributes it to the fund, or controls exist which identify stock to funds.</p> <p><u>Funds cannot be transferred</u> without independent approval from the relevant authorised person in accordance with authorisation limits.</p> <p><u>Bank reconciliations</u> should be performed frequently. "Frequently" could be daily for a large fund operating in several currencies (and of</p>

Risks	Key Controls
	<p>course any accounts servicing retail open ended funds) or, for more routine accounts, weekly or even monthly. They must be independently reviewed.</p>
<p><u>Systems' failures</u></p>	<p><u>Strict controls</u> operate when new programs are introduced to the live environment. Programmers have no access to live systems.</p> <p><u>Protection</u> which includes separate passwords for entry and authorisation. Remote connections switched off when not in use. Systems and discs are virus checked.</p> <p><u>Back up</u> records are maintained off site and disaster recovery arrangements are checked routinely.</p>
<p><u>Non-compliance with client instructions</u></p>	<p>Fund managers have a summary of <u>client authority</u> and restrictions which is updated whenever a change occurs. Key restrictions are recorded on the central dealing system which alerts the dealer before the trade is placed with the market. There is an independent review of deals</p> <p>Money market lending/borrowing must be <u>approved</u> by the relevant fund manager.</p> <p>The treasury dealing system maintains <u>records</u> of authorised counterparties and associated limits and restrictions.</p> <p><u>Monthly operational reports</u> from third party service providers are used to monitor performance against service level arrangements and instructions.</p>
<p><u>Counterparty failure</u> (including money market and foreign exchange counterparties)</p>	<p>The investment managers executive team, responsible to its board, <u>approves</u> all new counterparties and exposure limits.</p> <p><u>Credit ratings</u> from two credit agencies (when available) are used to determine creditworthiness.</p> <p>All money market and foreign exchange counterparties reviewed by the treasurer, supported by ad hoc reviews, when necessary.</p> <p>Money market and foreign exchange exposures <u>reviewed</u> by the treasurer and</p>

Risks	Key Controls
	<p><u>approved</u> by the investment director.</p> <p>The compliance department reviews the money market deposit summary weekly and the foreign exchange dealing sheets daily.</p>
<p><u>Settlement error</u></p>	<p>Broker confirmations are received for all deals. The <u>confirmation is matched</u> to trade records input by the central dealing department. Mis-matched/unmatched deals are investigated.</p> <p>Stock <u>delivery</u> can only be <u>against settlement</u>.</p> <p>Stock delivery instructions for matched trades are forwarded electronically to external custodians. Delivery instructions cannot be released unless approved by an authorised member of staff.</p> <p>Managers monitor the custodians' outstanding settlement reports to identify failed trades. All <u>failed trades are investigated</u>.</p> <p><u>Stock reconciliations</u> performed by external custodians are reviewed in-house and reconciled to in-house stock records.</p>
<p><u>Non-compliance with statute and regulations.</u></p>	<p>The company secretaries are all qualified chartered secretaries. Training is provided on a routine basis and an up to date reference library is maintained.</p> <p>Central compliance is supported by dedicated compliance representatives for each department.</p> <p><u>Quarterly compliance monitoring</u> programmes cover all activities.</p> <p>Compliance manuals are issued to compliance representatives and departmental managers.</p> <p>Regular compliance training for staff.</p> <p>Compliance monitoring programmes are regularly reviewed to ensure that they remain appropriate.</p>

Appendix B

**Some initial questions for directors to ask**

These are nothing more than a few ideas to help the thought process for those who wish to assemble their own procedures by means of enquiry.

### **Are responsibilities clear?**

- Under the investment management agreement, are the investment manager's responsibilities to the investment trust clear?
- Are the board's responsibilities and those delegated to service providers clear?
- How often does the board review that structure of responsibility?
- Does the trust have the equivalent of service level agreements with all its service providers?
- Is there a consistent benchmark for the fund?

### **At the service providers: Who takes an independent overview of whom?**

- How are duties segregated?
- In investment decisions, how is fair allocation, and no unfair preference, ensured?
- Are there documented procedures which clearly identify significant controls?
- How are errors/ breaches reported?
- To whom?
- How is remedial action followed up?
- Is there an internal audit function? Reporting how and to whom?
- How does compliance monitoring work?
- To whom does the compliance officer report?
- Does the compliance officer have direct access to the Chief Exec/Chairman of his service provider and does he meet the board of each trust?
- How, and how often, do compliance issues get reported to board?
- How often does the board call in the compliance officer for a face to face session?

### **How does the service provider identify matters relevant to a particular client?**

Relevant matters might arise from internal checks and procedures, regulator's visits and reports, or external reports such as FRAG 21s or SAS 70s. Any of those could have a bearing on a client investment trust. Relevant matters should be summarised for the trust board either to give assurance or show the way in which a matter of concern was resolved.

### **In day to day routines:**

How often are portfolios reviewed? By whom?  
What supervisory or peer group reviews occur?

## Deal placing

- How are brokers selected (since credit risk will be the trust's)?
- How are orders placed?
- What use of soft commission?
- How are executions reported to central dealers/fund managers?
- And to the custodian?

## Settlement

- How does the settlement process work?
- How are failed trades tracked?
- How often are cash/stock accounts reconciled?
- How long does it take to clear reconciling items?
- How are corporate actions handled?

## Valuation and accounts

- What is the valuation process and how is that reconciled to the accounting system?
- How are directors' valuations validated?

## **How does the audit committee and the board validate what it is told?**

- How does it compare its "risk map" against the reports which it receives?
- What is its annual programme of topics covered?
- Whom does it see personally and what independent assurance does it rely on to validate what it has been told?