



8 September 2014

By email (response@hkex.com.hk) and by post

Our Ref.: [REDACTED]

Corporate Communications Department
Hong Kong Exchanges and Clearing Limited
12/F, One International Finance Centre
1 Harbour View Street
Central, Hong Kong

Dear Sirs,

**Re. Consultation Paper on Risk Management and Internal Control:
Review of the Corporate Governance Code and Corporate Governance Report**

--- Please find attached a completed questionnaire from the Hong Kong Institute of CPAs ("Institute") in relation to the above consultation.

Generally, we are supportive of the proposal to extend the scope of the relevant parts of the Corporate Governance Code ("the Code") and Corporate Governance Report ("the Report") to cover risk management, in addition to internal control, for the reasons given in the consultation paper. Risk management and internal control should be seen as integrated activities and not as separate and unrelated functions.

We agree that the board should take overall responsibility for the risk management and internal control systems and that the management should report on the effectiveness of the systems. However, we feel that there is still room for greater clarity in the Code in delineating the specific roles and responsibilities of different stakeholders, including the board, management, audit committee and, potentially, the risk committee, if one is established, internal audit and external audit.

We also consider that the opportunity should be taken to clear up any ambiguities and overlap between the disclosure requirements of the provisions of the Code and the mandatory disclosure requirements in the Report. We have highlighted one such example in the response to question 9 in the questionnaire.



The importance to listed companies of having effective risk identification processes and risk management and internal control systems is not in doubt. The recent financial crisis demonstrates what can happen if boards do not have adequate oversight of these areas and do not fully understand the risks that the company is taking, and the communication between the management the board is not effective. In this regard, we firmly believe that having a professional accountant as an executive on the board, or as a member of the senior management, who has the knowledge and expertise needed to oversee the company's finance and accounting function, and the adequacy of its financial, as well as operational and compliance controls, is of fundamental importance.

The Institute expressed strong reservations about the removal of the requirement for listed companies to have a "Qualified Accountant (QA)", when this requirement was reviewed and, ultimately, removed in 2008. Although certain new requirements were introduced, specifically, the requirement in the Code, *that the board's annual review of the internal controls should, in particular, consider the adequacy of the resources, qualification and experience of staff of the issuer's accounting and financial reporting function, and their training programmes and budget*, and the requirement in the listing rules, *that at least one of the independent non-executive directors must have appropriate professional qualifications or accounting or related financial management expertise*, these requirements do not ensure that a qualified professional is employed by listed companies at the most senior levels.

The proposed change to the wording of the Code Provision, referred to above, which involves replacing "consider" with "ensure", and adding internal audit into the scope of resources to be included in the annual review, will not alter the above situation. Therefore, we would urge Hong Kong Exchanges and Clearing to consider reintroducing a requirement for a QA, who should be member of the Hong Kong Institute of CPAs, or a professional accountant of equivalent standing. In the case of an overseas- incorporated company, whose principal business and central management and control are outside Hong Kong, the QA might be a member in good standing, with requisite knowledge and experience (including knowledge of international financial reporting standards), of a national accounting body in the jurisdiction of the company's main base, who is properly regulated by a competent authority.



The reintroduction of a requirement for a QA would help to give greater assurance to investors as to the quality and effectiveness of issuers' risk management and internal control systems, as well as the internal audit function. Having a QA in place should be seen as, in itself, an important element of an effective risk management and internal control framework.

If you have any questions on our submission or would like meet to discuss it, please contact [REDACTED] in the first instance.

We apologise for the slight delay in responding.

Yours faithfully

[REDACTED]

[REDACTED]

Encl.

[REDACTED]

Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEx website at: <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201406.pdf>

Where there is insufficient space provided for your comments, please attach additional pages.

1. Do you agree with our proposal to amend the title of Section C.2 of the Code to “Risk management and internal control”?

Yes

No

Please give reasons for your views.

As the consultation paper explains (paragraph 22), a review of global developments indicates that internal control is now seen as an integrated part of risk management and, conceptually, not as a separate issue. We agree with this approach. The Hong Kong Institute of CPAs ("the Institute")'s 2005 guidance, which was published at the request of the Stock Exchange, prior to the introduction of the internal control requirements (in the then Code on Corporate Governance Practices), was entitled, "*Internal Control and Risk Management – A Basic Framework*" and covered both areas, as part of an overall framework.

2. Do you agree with the proposed amendments to Principle C.2 to define the roles of the board and the management, and state that the management should provide assurance to the board on the effectiveness of the risk management systems? Is the intention of the proposed wording sufficiently clear?

Yes, but note the additional points raised in the response below

No

Please give reasons for your views.

We agree on the need to delineate more clearly the roles of different parties within an issuer in relation to risk management and internal control. We also agree that management should give assurance to the board on the effectiveness of the risk management systems (although additional information could usefully be provided as to what kind of assurance is envisaged). While these are well accepted principles in internal controls/risk management best practices, the intentions underlying these principles may not be too clear in Appendix 14, as a stand-alone document. In this regard, we refer you to the Institute's recent disclosure guide on this subject, "*A Guide on Better Corporate Governance Disclosure*" <http://www.hkicpa.org.hk/en/membership-and-benefits/professional-representation/corporate-governance/publications/gov-publications/cg-practices/> In that publication, we explain that the board would need to formulate its own review process, including obtaining assurances from various stakeholders (like management, internal audit, and external audit). The board should also satisfy itself that such assurances are well grounded.

3. Do you agree with our proposal to introduce an amended RBP (C.2.6) to provide that the board may disclose in the Corporate Governance Report that it has received assurance from management on the effectiveness of the issuer's risk management and internal control systems? Is the intention of the proposed wording sufficiently clear?

Yes, but we suggest considering making this a CP rather than a RBP

No

Please give reasons for your views.

As this is a proposed RBP, a clearer stand should be taken on what should be regarded as good practice. As it is generally seen as good practice for the management to give such assurance (in fact, the proposed revised Principle C.2 expects this) and disclosure should in itself be seen as good practice, the RBP should state that this information should be disclosed. Given the proposed Principle C.2, we would further suggest that consideration be given to turning the disclosure of the management's assurance into a CP. This way, if disclosure is not forthcoming, this will provide relevant information to investors about the risk management and internal control systems of the issuer. It will also give the board an opportunity to explain why such assurance has not been provided, as well as any follow up/remedial action that the board has taken.

4. Do you agree with the proposed amendments to CP C.2.1 to state that the board should oversee the issuer's risk management and internal control systems on an ongoing basis? Is the intention of the proposed wording sufficiently clear?

Yes

No

Please give reasons for your views.

The proposed wording suggests that the board should seek and receive regular reports on the operation of the risk management and internal control systems, which should include how key risks are being managed, and any changes in the major risks facing the issuer. In our view, this would be appropriate.

5. Do you agree with our proposal to upgrade to a CP the existing RBP C.2.3, which sets out the matters that the board's annual review should consider?

Yes

No

Please give reasons for your views.

Yes, generally, these are areas that should be considered in the annual review. In relation to item "(d), significant control failings or weaknesses...", some further guidance or definition of what would fall into this category would help issuers. We would also suggest adding the underlined wording below, to the end of the first phrase. The whole phrase would then read: "significant control failings or weaknesses that have been identified during the period and how these have been or will be remedied".

6. Do you agree with our proposal to upgrade to a CP the existing RBP C.2.4, which sets out the particular disclosures that issuers should make in their Corporate Governance Reports in relation to how they have complied with the internal control CPs during the reporting period?

Yes, but subject to certain qualifications and clarifications in the detailed response below

No

Please give reasons for your views.

Generally, these are areas that should be disclosed in an issuer's Corporate Governance Report. To be more consistent with the proposed revised CP C.2.1, in the first arm of (c), it may be better to refer to an acknowledgment by the board that it is responsible for oversight of the risk management and internal control systems. It is also for consideration whether this should be a mandatory disclosure requirement under the Corporate Governance Report, section Q, rather than a CP.

Due to the structure of the code, the implications of not including in the Corporate Governance Report (i.e., in Section Q) an acknowledgment by the board that it is responsible for the risk management and internal control systems and, instead, making this a "comply or explain" disclosure, could be somewhat ambiguous.

7. Do you agree with our proposal to amend the wording of proposed CP C.2.4 to simplify the requirements and remove ambiguous language, and to make clear that the risk management and internal control systems are designed to manage rather than eliminate risks? Is the intention of the proposed wording sufficiently clear?

Yes

No

Please give reasons for your views.

It would be prudent for the management to make the suggested clarification, which should make it clear to investors that having effective risk management and internal controls systems does not amount to eliminating all risk.

8. In relation to proposed CP C.2.4, do you agree with our proposal to upgrade the existing recommendation that issuers disclose their procedures and internal controls for handling and disseminating inside information (Section S., paragraph (a)(ii)), and amend it to include the handling of "other regulatory compliance risks"?

Yes, partially

No, partially

Please give reasons for your views.

We would agree with upgrading the existing recommended disclosure in relation handling and disseminating inside information to a CP, but not to extending this to "other regulatory compliance risks", which would be a new, and rather open-ended, requirement. In addition, this is not necessary, as compliance risks should, by implication, already be covered under the proposed CP C.2.4 (a) which requires the disclosure of "the process used to identify, evaluate and manage significant risks". Compliance controls are also specified as being a key component of the scope of the board's annual review, so it could be confusing to require separate disclosure of internal controls around compliance risks, while not doing so around financial or operational risks.

9. Do you agree with our proposal to upgrade to Mandatory Disclosures the following existing Recommended Disclosures in relation to internal controls (Section S.):

- (a) whether the issuer has an internal audit function;
- (b) how often the risk management and internal control systems are reviewed, the period covered, and where an issuer has not conducted a review during the year, an explanation why not;
- (c) a statement that a review of the effectiveness of the risk management and internal control systems has been conducted and whether the issuer considers them effective and adequate; and
- (d) significant views or proposals put forward by the audit committee?

Yes, mainly, subject to the qualifications below

No, partially

Please give reasons for your views.

Although, generally, we support this proposal, we have reservations regarding the inclusion of item (d), which could discourage the audit committee from being open and frank with the management and the board. However, if the audit committee has indicated some disagreement with the assessment reflected in (c), this should be disclosed.

The current review provides a good opportunity to address some of the ambiguities in the existing code, but the proposal may not completely achieve this. For example, item (b) requires disclosure where an issuer has not conducted a review of the risk management and internal control systems during the year and an explanation why not. However, this would appear to overlap with the proposed revised CP C.2.1, which requires the board to ensure that a review of the effectiveness of these systems be conducted at least annually. As CP C.2.1 is a "comply or explain" requirement, the structure of the code would seem to require an issuer that has not conducted a review to acknowledge that fact and to explain why it has not done so. How these two, apparently overlapping, requirements (one a proposed mandatory disclosure and the other a "comply or explain" CP) relate to one another needs to be clarified.

10. Do you agree with our proposal to move the existing recommendation that issuers disclose details of any significant areas of concern (Section S., paragraph (a)(ix)) to a new RBP C.2.7, and to amend the provision to widen its application by removing the reference to areas of concern "which may affect shareholders"?

Yes, but with the qualification indicated below

No

Please give reasons for your views.

While we have no objection to an RBP, that "[t]he board may disclose in the Corporate Governance Report details of any significant areas of concern", this may be too broad to encourage to issuers to expand their disclosure. It may also be worthwhile to make clear that any matters that may constitute inside information would be subject to the statutory regime governing the disclosure of such information.

11. Do you agree with our proposal to remove RBP C.2.5, which states that issuers should ensure their disclosures provide meaningful information and do not give a misleading impression?

Yes

No

Please give reasons for your views.

We agree with the rationale provided at paragraph 76 of the consultation paper.

12. Do you agree with our proposals to remove the recommendations that issuers include in their Corporate Governance Reports:

(a) an explanation of how the internal control system has been defined for them (Section S., paragraph (a)(i)); and

(b) the directors' criteria for assessing the effectiveness of the internal control system (Section S., paragraph (a)(vii))?

Yes

No

Please give reasons for your views.

We agree that (a) is not very clear. As regards (b), this should already be adequately covered by the proposed revised CP C2.4(d).

13. Do you agree with our proposal to upgrade RBP C.2.6 to a CP (re-numbered C.2.5) and amend it to state that an issuer should have an internal audit function, and issuers without an internal audit function should review the need for one on an annual basis and disclose the reasons for the absence of such function in the Corporate Governance Report? Is the intention of the proposed wording sufficiently clear?

Yes, with the qualification indicated below

No

Please give reasons for your views.

We agree with this proposal and on the importance of having an internal audit function. The consultation paper notes, at paragraph 79, that "the internal audit function plays an important role in ensuring the effectiveness of an issuer's risk management and internal control systems" and that "it is often seen as the third line of defence". It also points out that some even take the view "that it may be impossible to have an effective internal control system without an internal audit function". Stock markets in a number of other jurisdictions make it a requirement to have such function. Under the circumstances, it may not be sufficient for issuers without such a function to re-consider the issues only on an annual basis. We would suggest that consideration be given to requiring issuers to review the need on a half-yearly basis.

During the soft consultation, the Institute was one of the stakeholders that expressed reservations about requiring an in-house internal audit function and suggested that this should be allowed to be outsourced, to accommodate smaller less-well-resourced issuers, which could have difficulty recruiting suitable staff. We pointed out that this was regarded as acceptable to the internal audit profession. We note also that this practice is also accepted as compliance in the case of a number of similar corporate governance codes overseas. We are pleased to see, therefore, that the point has been taken on board in the current consultation paper (e.g., paragraphs 80 and 88). We would suggest that, for the avoidance of doubt, this matter be made more explicit in CP C2.5, by, for example, adding another note, along the lines of the following:

3 Compliance may be achieved either by way of establishing an in-house internal audit function or outsourcing the function to competent persons.

14. Do you agree with our proposal to introduce new Notes to the proposed CP C.2.5 to clarify that:

- (a) the role of the internal audit function is to carry out the analysis and independent appraisal of the adequacy and effectiveness of an issuer's risk management and internal control systems; and
- (b) a group with multiple listed issuers may share group resources of the holding company to carry out the internal audit function for members of the group?

Yes, partially

No, partially

Is the intention of the proposed wording sufficiently clear? Please give reasons for your views.

It may be better to make reference to an existing definition of the role of internal audit in Note 1. The website of the Institute of Internal Auditors defines internal auditing as *"an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."*

An extract or modified version of the above may be suitable.

As regards, Note 2, if, as we suggest in the response to question 13 above, it is made clear that compliance may be achieved either by way of establishing an in-house internal audit function or outsourcing the function, there may be no need for the second note. Furthermore, as currently proposed, the note could give rise to various questions, such as whether resources sharing among holding companies and their listed subsidiaries could constitute a continuing connected transaction, and whether, for Mainland state-owned enterprises, certain types of audits by government departments could be regarded as an internal audit function of the listed issuers.

15. Do you agree with our proposal to amend the existing CP C.2.2 to state that the board's annual review should ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's internal audit function (in addition to its accounting and financial reporting functions)?

Yes, partially

No, partially

Please give reasons for your views.

In the light of the response to question 13 above, and the proposals in the consultation paper, it should be recognised that internal audit function may be outsourced and the wording should clearly reflect this. We would suggest something along the lines of the following:

The board's annual review should, in particular, ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's accounting, internal audit and financial reporting functions. Where the internal audit function is outsourced, the board should ensure the adequacy of the budget and that every effort is made to outsource to competent persons with sufficient resources to carry out the function.

In addition, we would draw your attention to an issue raised in the covering letter, namely that consideration should be given to reintroducing the requirement previously in the listing rules for issuers to employ a "qualified accountant". This would ensure that issuers have a competent individual to assist the company in fulfilling its financial reporting obligations and developing and maintaining effective risk management and internal controls in relation to financial and other matters.

16. Do you agree with our proposal to amend Principle C.3 in respect of audit committees and CP C.3.3 in respect of their terms of reference to incorporate "risk management" where appropriate?

Yes, possibly, but subject to further consideration of the issues raised below

No

Please give reasons for your views.

In principle, yes, for the reason given in response to question 1, above, that internal control is now seen as an integrated part of risk management and, conceptually, not as a separate activity.

However, while we agree that it is the board's responsibility to oversee the issuer's risk management and internal control systems on an ongoing basis, we have some reservations about continuing to channel this into the terms of reference of the audit committee, without further consideration, and in the light also of the other changes being proposed to the code. It could be, for example, that the board decides to set up a separate risk committee, as envisaged in question 17 below. What then would be the interface between the work of the audit committee and that of the risk committee? Now that the listing rules require that audit committees comprise only non-executive directors, are they the best vehicle to take up oversight of the review of risk management on behalf of the board, given that risk and controls relating to business operations will be an important part of the process? Where there is an internal audit function, how do the respective roles of internal audit and the audit committee/ risk committee relate to one another? See also the response to question 17 below.

17. Do you agree that the matter of establishing a separate board risk committee should be left to issuers to decide in accordance with their own circumstances?

Yes, but subject to qualifications below

No

Please give reasons for your views.

Yes, for the reasons given in the consultation paper (paragraph 95 refers). However, if an issuer chooses to set up a separate risk committee, unless, as provided for in the Australian code, it is part of (or a subcommittee of) the audit committee, then the Hong Kong code would need to make allowances for this, as, it seems, the UK code has done. If the Stock Exchange were to accept the establishment of a separate risk committee, which assumed the role and responsibilities currently proposed for the audit committee in relation to risk management and internal control, as complying with the code, then CP C3.3 would need to explain that the relevant terms of reference may, instead, be taken up by a risk committee.

The composition of a risk committee should also be considered. We understand that, in the US, risk committees must have an independent chair. While, as we suggest in the response to question 16 above, it is appropriate that some executives should be able to participate in oversight of the review of the risk management and internal control systems, there is also a case for requiring that the relevant committee should be chaired by an independent director, particularly in the light of the apparent pressure on companies in certain sectors to take on excessive amounts of risk for higher returns.

18. What would be an appropriate period of time between the publication of the consultation conclusions and the implementation of the amendments set out in the Consultation Paper?

Six months

Nine months

12 months

Others (please specify:)

Please give reasons for your views.

Given the substantial changes that some issuers would need to make in order to integrate their risk management and internal control functions and systems, including recruiting suitable personnel, a reasonable lead time should be allowed. Issuers should be encouraged to implement the changes early. In the case of some larger and well-governed issuers, the changes required to implement the new requirements will not be substantial.

- End -