November 2023

A Snapshot of INEDs' Roles and Responsibilities

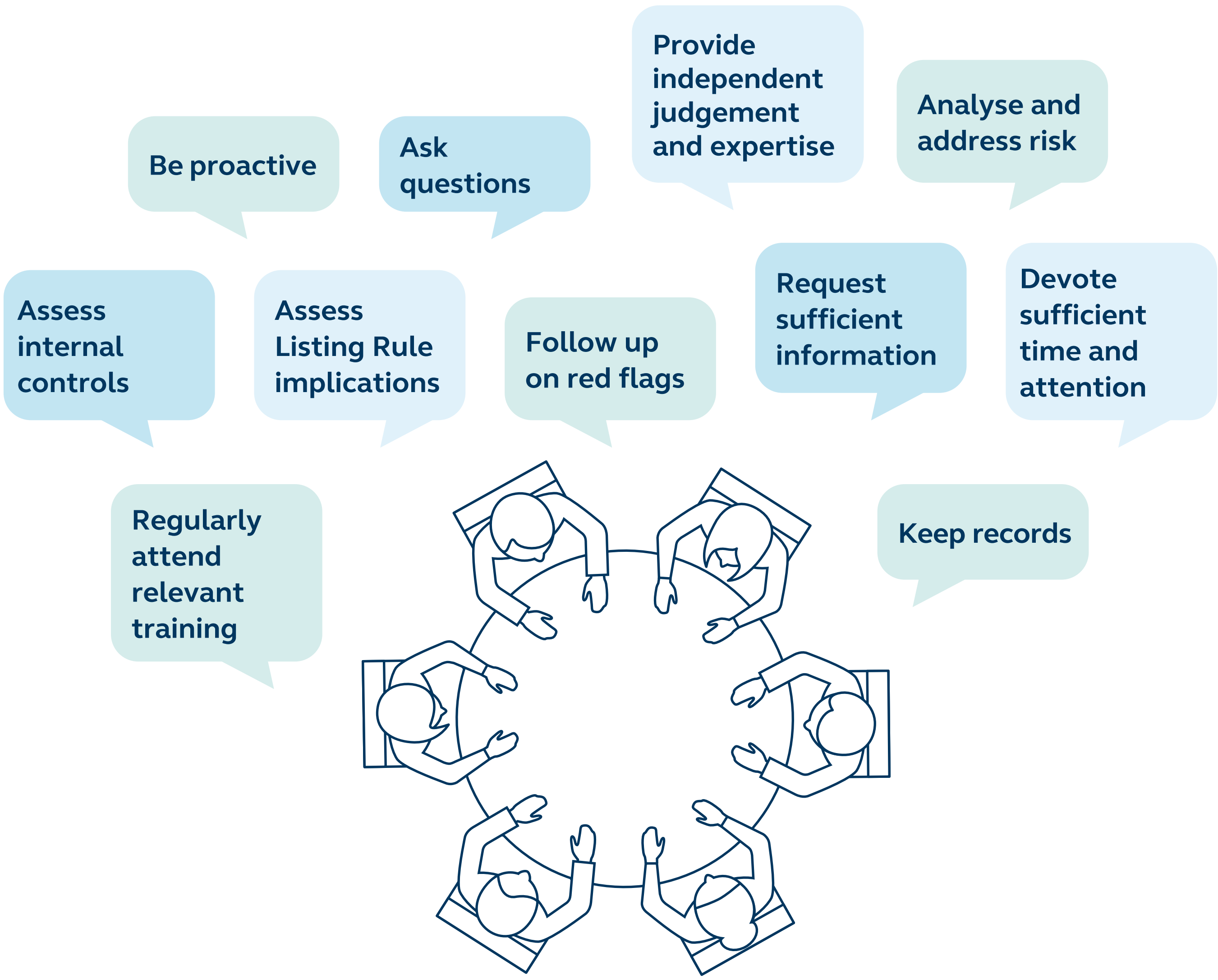
As an independent non-executive director (INED), you are, by definition, an independent member of the board of directors of a company (or an issuer). You are the external "extra pair of eyes" for the company, and your expertise and experience contribute to the company's success. You play a key role in respect of the Board's oversight of the company's risk management and internal controls. Among other areas, your contribution is important to the development of the company's strategy and policies through independent and constructive comments and questions.

INEDs have a number of responsibilities and obligations as set out in the Listing Rules, including the Corporate Governance Code, and they have an important role to play to ensure their companies meet their governance requirements as listed and regulated entities.

This document provides a quick and easy-to-follow overview of INEDs' key responsibilities and obligations to help directors in Hong Kong better understand what is expected of them and how they can fulfill their duties. It covers their key duties in the areas of business decisions, internal controls, financial reporting and incident management. It is meant to be used as a guide only, not as a checklist for all expected duties.

We encourage you to read it, bookmark it and refer to it whenever you are acting in your role as an INED.

An INED should...



First things first – take these actions when you become a new INED

Whether or not it's your first board position, when you join a company as an INED, get your bearings right and take these actions.

- Understand the company's business(es)
- Take a fresh look at the internal controls
- Apply independent judgement and expertise to comment objectively on the existing framework and documentation for internal controls
- Review the compliance history relating to the Listing Rules, laws and regulations, and understand the causes of non-compliance, remedial actions and implementation status
- Do not simply rely on management's representation of the company without making further enquiries or exercising independent judgement
- Ensure that there are mechanisms for regular flow of information and timely reporting of material information to you and the other directors, and for obtaining further information if required
- Devote sufficient time and attention to the company's affairs to discharge your responsibilities effectively
- Proactively attend training on topics relevant to new appointment
- Adopt good practices of documenting own contributions to the Board and keep important records circulated and produced during the course of appointment

Case Study 2

What is your role in the review and approval of business decisions and transactions?

As an INED, you help contribute to the company's success by bringing your expertise and experience. You are expected to cast an eye over the company's business decisions and transactions.

- Ensure there is sufficient information to make informed decisions on the matters at hand
- Participate and ask questions – raise concerns with the board of directors and exercise independent judgement. Do not merely rely on responsible directors or representations of executive management
- Give due interest to agenda items even if the matters may not be within your responsibility or expertise
- Even if you are not attending a Board meeting, consider the agenda items and obtain minutes of the meeting, raise enquiries before, or follow up after, the meeting, or both
- Independently assess professional advice and the reasonableness of valuations
- Take steps to ensure that the control environment takes into account any changes to the company's business and operations
- After a business matter or transaction is approved, ensure that there is a mechanism in place for follow-ups on the proper conduct of the business, implementation and Listing Rule compliance
- Carefully review corporate communications and any other documents (such as monthly financial reports) of the company presented to directors for consideration and ensure accuracy and completeness of information
- Ensure that contributions and concerns are properly recorded

When a transaction or a new business is being proposed and approved, what questions should be asked and followed up on?

Is it in the interest of the company?

Has sufficient due diligence been conducted?

What are the Listing Rule implications and compliance?

Is it in proper compliance with internal procedures?

Have the risks been analysed and addressed?

Has there been a consultation with professional advisers?

▶ Case Study 4

▶ Case Study 5

What is your role in internal controls?

Together with other Board members, you are collectively, and individually, responsible for ensuring that the company establishes and implements adequate and effective internal control and risk management systems.

- Take an active role in designing, implementing, reviewing and monitoring the effectiveness of the company's internal controls and procedures
- Independently assess and review the internal controls and procedures. Do not simply rely on representations by management
- Ensure that annual reviews are carried out and that internal control reviews cover all material controls. Reviews covering only selected internal control cycles on a rotation basis are a deviation from the Corporate Governance Code
- In annual reviews, among other areas, ensure the review of the adequacy of resources, qualifications and experience among the staff; and that regular training has been provided to management and staff
- Proactively consider the necessity, and establish and implement controls and procedures as appropriate for new businesses and transactions
- Set up mechanisms by which information and documents regarding the operations, development, financial performance and risks of new businesses, subsidiaries and/or joint ventures, will be provided to INEDs for review and assessment
- Establish appropriate policies and guidelines governing the investments, and request regular updates of the status and performance of the investments to directors
- Assess and ensure that internal controls do not only exist on paper but are properly implemented in the day-to-day business operations by management and staff
- Where internal control deficiencies are identified, take steps to ensure that they are properly addressed and rectified. Regular meetings and reporting should take place to monitor the progress of implementation of remedial measures and enhancements

What is your role in financial reporting?

As an INED, you should take proactive steps to ensure that the company meets its financial reporting obligations, including ensuring that the company's financial statements give a true and fair view of the company's financial position.

- Establish procedures to ensure keeping of accurate books and records
- Ensure there is sufficient and clear information to enable a regular and informed review of financial data and other information
- Pay attention to possible red flags – proactively raise enquiries, be wary of unusual patterns of transactions, significant expenses or outflow of money
- Understand what the auditors' concerns are, take proactive steps to obtain the company's financial statements and ensure that they provide a true and fair view of the state of affairs of the company and its operational results and cash flows
- Closely monitor the audit progress and regularly meet with management and auditors to ensure any audit issues are timely addressed

▸ Case Study 1 ▸ Case Study 3 ▸ Case Study 4

What is your role in incident management?

As an INED, you should, with your expertise, experience and independent judgement, act promptly and proactively to deal with any issues.

- Understand and investigate the issues brought to the attention of the Board
- Upon discovery of non-compliances and/or other issues, promptly review and discuss among the Board and take appropriate action to:
  - Address the issues, rectify or remedy the breach
  - Reassess any internal controls and take measures to prevent future Rule breaches
- Where red flags have been highlighted, tangible efforts should be made to investigate, and follow up on whether, and how, the red flags have been addressed
- Consider Listing Rule implications and disclosure or reporting requirements
- Apply independent judgement to incident assessment and do not simply rely on management to address possible compliance issues
- When the Exchange makes enquiries of the company, take steps to follow up and ensure that the company accurately responds to the enquiries in a timely and substantive manner
- Ensure that incident responses are properly documented
- Consider and encourage training of the Board, management and staff to prevent future incidents

Some real-life case studies of issues faced by INEDs are set out on the next page.

Real-life case studies of issues faced by INEDs

Case study 1 - Financial reporting issues

The Company had been late for a couple of days in publishing its annual results for two consecutive financial years (FY1 and FY2). It started preparing its annual results for FY3 in mid-December. The Company's financial year ends on 31 December.

During the audit of the Company's financial statements for FY3, the Company's auditors discovered that ED A and the CFO had transferred significant sums of the Company's cash into their own bank accounts; and caused the Company to make significant loans to ED A's wife which were repayable on demand and interest free. The transfers and loans were made without the Board's approval or anyone else's knowledge; they were not properly documented or recorded in the Company's books and records. The Company's auditors reported these matters to the Board.

What should you do as directors, including the INEDs?

Do's	Don'ts
FY1 and FY2 financial reporting delay:	
We need to find out why the results were delayed in FY1 and again in FY2; we can't let that happen again. Let's look at the Company's internal controls for financial reporting and make sure any deficiencies are remedied. We must keep an eye on this and make sure the staff report any issues and we know about any difficulties encountered so we can implement measures to address them.	No need to look into this. The annual results were only two days late. There was no impact to the market caused by the delay.
Timely FY3 financial reporting:	
(Audit Committee) Let's meet with the Company's auditors as soon as possible after the financial year end to discuss the nature and scope of the audit and reporting obligations before the audit commences. We should set up a timetable and liaise with the auditors regularly to monitor the progress of the audit and discuss with the auditors and the Company's executive management. We need to address any audit issues in a timely manner.	(Audit Committee) Let's wait for the draft results from the Company or its auditors. They should have highlighted and addressed the issues by the time we come to approve the results.
Dealing with audit issues:	
Let's convene a meeting to discuss. We need to take action now to: • Ascertain the Listing Rule and legal implications of the transfers and the loans. For example, do we need to consult professional advisers, and take steps to procure the Company's Rule compliance as soon as practicable, including announcing the transactions? • Arrange an investigation on the transfers and the loans, including ascertaining why they had happened. • Arrange for a review of the Company's internal controls, to ascertain why the transfers and the loans had taken place without the knowledge and approval of the other Board members and why they had not been detected until the audit. • Take steps to recover the transfers and the loans, including, where appropriate, bringing legal action, reporting the matters to the police and/or suspending the duties of ED A and the CFO. • Ensure that the internal control reviewer's recommendations on improving the Company's internal controls are implemented properly and in a timely manner.	The executive directors will sort them out. Let's wait for them for updates.

◂◂ What is your role in financial reporting?

Case study 2 – Keeping apprised of affairs of the Company / Group

The Company's monthly management accounts for the Group are only circulated to the executive directors. The non-executive directors and INEDs do not receive any monthly updates. They only receive information from the Company when they are asked to attend Board meetings for reviewing and approving transactions and/or financial results.

What should INEDs do in this situation?

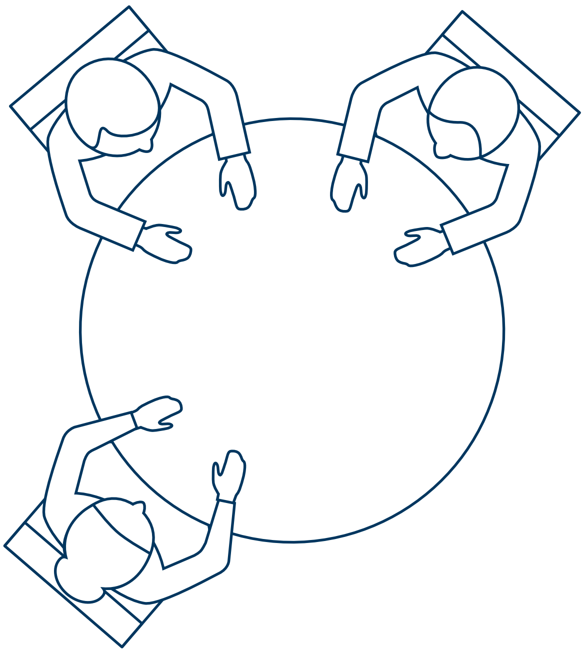
Do's

Director A
We must press the executive directors to provide all Board members with monthly updates which give a balanced and understandable assessment of the Company's performance, position and prospects in sufficient detail to enable the Board as a whole and each director to discharge their duties. We must be proactive and ask for monthly updates from the Company, review them carefully, and raise any questions which we may have.

Director B
I have made requests for monthly management updates to the company secretary but have received nothing to date. I will make requests to the Board Chairman and the executive directors in writing, so that there will be a written record of my requests. I will also raise the matter for discussion at the coming Board meeting.

Don'ts

Director C
This arrangement is absolutely fine – it weeds out unnecessary information which requires our review and therefore saves our time. The executive management would let us know if problems arise and/or our input is required.



First things first – take these actions when you become a new INED

Case study 3 - Suspicious movement of funds and red flags

The Company's monthly management accounts for July 2022 showed circular payments involving receipt of a significant sum from one of the controlling shareholder companies on 30 June 2022, and the return of the same amount to the same controlling shareholder company on 1 July 2022 – either side of the Company's end of year financial reporting period.

In addition, the management accounts show that the amount of receivables as at the end of July are significantly higher than as at end of June 2022.

What should INEDs do in this situation?

Do's	Don'ts
I don't think we should rely on the executive directors and the CFO, and we should review the accounts in detail to see if there are any issues which need to be raised for discussion. Why are there circular payments involving the same amount and party within two days? In addition, what are the reasons for the significant increase in the amount of receivables? We do not seem to have sufficient information for our consideration, and so we should ask for more information from the executive directors, including the purpose and/or nature of the payments and receivables. We should also consider whether there are any Listing Rule implications and if so, we should take steps to procure the Company's Rule compliance. If in doubt, we should procure the Company to seek professional advice, and arrange for the Company's management to report to us the advice and the implementation of the steps taken to procure Rule compliance.	I have only casually reviewed the accounts – the Company's executive directors have reviewed them after the CFO's preparation, and so they should be in order. I am not responsible for the day-to-day running of the Company's business and so have no obligation to review the accounts. In addition, the executive directors would certainly raise anything special for our attention.

◀◀ What is your role in financial reporting?

Case study 4 – Prior undisclosed transactions mentioned in financial and annual reports

The draft annual report of the Company for the financial year ended 31 December 2021, which was presented at the Board meeting for considering and approving the report, recorded that there were a number of disposals of the Company's subsidiaries at nil or minimal consideration during the year.

What should you do as directors, including the INEDs?

Do's

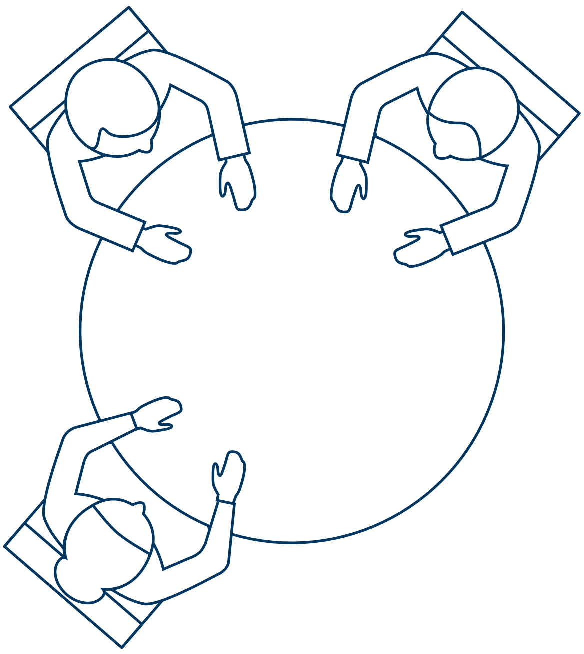
Director A
I knew I would not be available to attend the meeting but I reviewed the draft report in detail before the meeting. The report mentioned a number of disposals but I was never informed about them. I have circulated my comments to the Board before the meeting, and have asked for more information regarding the disposals – including the reasons for and commercial rationale of the disposals; why we were not previously told about them; whether there are any Listing Rule implications and, if so, steps must be taken to comply with the Rules as soon as possible.

I also asked why the Company's internal controls have not been able to identify and detect any failings; and what are the steps taken to improve the internal controls so that such failings do not happen again. I will also read the draft and final version of the minutes of the meeting to fully understand what has happened, and to see whether there are any matters which require follow-up.

Director B
I have the same issues which Director A raised. I attended the meeting and have raised them for discussion with the Board. The Company did not comply with the Listing Rules for the disposals, and there were internal control deficiencies – steps will now be taken to address these matters. To ensure that we can properly follow up on these matters, we have established a reporting mechanism in respect of the implementation of the remedial measures.
I will also make sure that the issues I raised are fully recorded in the meeting minutes.

Don'ts

Director C
As I was unavailable to attend the meeting, I did not review the draft report. I should not be held responsible for anything in respect of the report as I did not approve it. The executive directors would let me know if anything from me is required.



When a transaction or a new business is being proposed and approved, what questions should be asked and followed up on?

What is your role in financial reporting?

Case study 5 - Red flags in acquisition of new businesses

The Company principally manufactures and sells clothing and shoes. It intends to acquire a target company (Target) which is engaged in the manufacture and sales of Product A (totally unrelated to clothing and shoes) in Country Y.
The government of Country Y has granted a licence to the Target to manufacture and sell Product A for five years.

The Target has no track record and has not commenced business. None of the Company's directors have experience in the Product A business, which is new to the Company, or the laws and regulations of Country Y.

The proposed consideration for the acquisition is $200 million, being 75% of the Company's market capitalisation. The valuation of the Target is based on, amongst others, the following assumptions: (a) the business of manufacturing and selling Product A can last for ten years; (b) the estimated sales volume for the first year would be 3 million units; and (c) the sales volume would increase 100% per year for the second and third years. The sole director and shareholder of the Target (Mr X) will provide a profit guarantee to the Company – he would compensate the Company twice the amount of the difference in the profit amount per year.

The Company has engaged a number of professional advisers to advise on the proposed acquisition, e.g. a valuer, an accountant, a financial adviser (but does not advise on the merits of the acquisition), and lawyers. All the documents and information in respect of the Target and its business are provided by the vendor.

How can the INEDs demonstrate exercise of due care, skill and diligence regarding the acquisition?

Do's	Don'ts
We need to carry out appropriate due diligence, and make due enquiries, on the Target and relevant parties to the transaction.	We already have the company registration documents for the Target. Let's not waste further money.
We need to take steps to verify the documents and the accuracy / reasonableness of the information provided by the vendor, and raise questions.	The vendor has given us lots of materials about this acquisition. Let's rely on them.
We need to critically assess the valuation, including the reasonableness of the assumptions adopted. In addition, we should consider seeking professional advice to advise on the merits of the proposed acquisition and any legal implications (e.g. extension of the licence and other licensing requirements).	The valuer is a reputable company, and we can safely rely on its valuation. I don't have any expertise in this new business.
We should critically assess the proposed business plan of the Target and the benefits of the acquisition.	The business forecast looks profitable. What a great deal! Let's proceed anyway.
We must consider the reasonableness and adequacy of all the terms of the proposed acquisition, including the financial capability of Mr X to fulfil his obligation under the profit guarantee.	Let's sign the papers now. Don't worry – we have a profit guarantee to fall back on.
Have we considered the Listing Rule implications? We must set up mechanisms to ensure that the Listing Rules are complied with.	The company secretary will take care of the Listing Rule requirements. Let's just focus on the business aspects of the acquisition.
Now that the acquisition is approved, we need to set up a reporting mechanism to ensure that the business and operations of the Target are reported to us on a regular basis. We should also review the internal controls to ensure that they take into account the new business.	We have approved the acquisition. The staff will take care of the rest. No doubt, they will let us know if there are any issues requiring our attention.

When a transaction or a new business is being proposed and approved, what questions should be asked and followed up on?

(Readers can also refer to the article on directors' responsibilities when assessing transactions set out in the Exchange's newsletter of December 2021.)

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