



Enforcement Bulletin

Spotlight on internal controls

Every issuer listed on the Exchange is expected to have in place a comprehensive and effective internal control and risk management framework. This is an essential component of investor protection and market quality. The public expect and deserve that the companies in which they invest are operating with a culture and in an environment in which risks are appropriately assessed and addressed.

Having an appropriate framework is also important to mitigate against the following potential consequences: first, the issuer may be exposed to an unnecessary and unacceptable level of risk, which in turn can lead to a negative impact on its business or assets, whether in the form of financial losses or otherwise; second, the issuer and the responsible individuals may find themselves facing regulatory action.

In this edition of the Enforcement Bulletin, we focus on the important subject of internal controls.

Who is responsible for internal controls?

The board is responsible for ensuring that internal controls are appropriate and effective. The principle of collective and individual responsibility applies in this regard. All members of the board have a role to play in respect of implementation and oversight of internal controls.

The Corporate Governance Code notes the particular role to be played by the audit committee and risk committee in respect of internal controls.

Typical enforcement case

In many of the cases which are the subject of enforcement action, there will be evidence from the outset of a potential breach, such as a failure to comply with disclosure requirements relating to a transaction, or a significant loss incurred in circumstances which call into question whether the directors have discharged their duties. In such cases, whilst part of our focus will of course be on whether this problematic event involves a breach, we will also investigate the issuer's internal controls, and the steps that the individual directors have taken to discharge their responsibilities in respect of internal controls.

Put another way, if a problematic event occurs, we do not just look at that event, but we also look at whether the issuer has been run in a manner which appropriately mitigated the risk of problematic events or non-compliance. If there has been a failure in respect of internal controls, then disciplinary action may follow on that alone, even if we ultimately establish that the matter which caused us to begin our investigation involved no breach or misconduct.

By looking through our recent [disciplinary sanctions](#), you can find many examples which illustrate our approach towards internal controls. We have also highlighted this in our round-up of recent enforcement cases in this edition of the Bulletin.

If directors fail to discharge their duties in respect of establishing or maintaining effective internal controls, then they risk being publicly sanctioned. In appropriate cases, we may also direct the issuer to undertake an internal control review, and to confirm when it has addressed any deficiencies and implemented recommendations arising from the review.

Guidance on internal controls

In the following article, we go into more detail about how we assess whether duties have been discharged in respect of internal controls. We also set out some suggested references for further guidance.



Guidance on internal controls

It is well known that every issuer’s business and circumstances will be different, and so there can be no “one-size-fits-all” approach to internal controls, or universal checklist. But there are several important areas that will be common to, and therefore require attention in, almost every issuer.

Below, we: (a) outline some of the things that we will look for when investigating whether an issuer has adequate internal controls, and whether directors have discharged their duties; (b) address some mistakenly-held beliefs; and (c) provide references to further reading and guidance.

What we look for

The Corporate Governance Code has several provisions relating to internal controls – see, for example, the following provisions in Part 2:

- Principle D.2: “The board should oversee management in the design, implementation and monitoring of the risk management and internal control systems, and management should provide a confirmation to the board on the effectiveness of these systems.”
- Provision D.2.1: “The board should oversee the issuer’s risk management and internal control systems on an ongoing basis, ensure that a review of the effectiveness of the issuer’s and its subsidiaries’ risk management and internal control systems has been conducted at least annually and report to shareholders that it has done so in its Corporate Governance Report. The review should cover all material controls, including financial, operational and compliance controls.”

In our investigations, we will typically ask for evidence of the internal controls that are in place, and the steps that have been taken to review them, and to ensure that the controls are implemented and operating effectively. In accordance with D.2.1, we would normally expect to see that reviews have been conducted at least annually.

It requires substantial time and resources to ensure the effectiveness of internal controls on an ongoing basis. We would normally therefore expect an issuer and individual directors to be able to refer to detailed documentary evidence to demonstrate that the internal controls are being reviewed and enhanced where necessary – quite literally there should be an “audit trail”. The absence of substantive documentary evidence, showing a detailed and methodical approach to the maintenance of effective controls, and that staff have been trained on appropriate practices and procedures, is often an indicator that insufficient resources have been applied.

We will also seek in our investigation to get an understanding of an issuer’s culture towards internal controls and Rule compliance. This goes beyond having in place policies and procedures. A positive indicator of a good culture will be if it is possible, at all levels of the organisation – from the board to the most junior employee, to raise concerns if an individual believes that something is wrong. In this regard, Provision D.3.7(a) of the Corporate Governance Code notes that the audit committee should review an issuer’s arrangements so that employees can raise such concerns.



Some misunderstandings dispelled

In our enforcement work, we sometimes encounter what appear to be misunderstandings on the part of directors as to what is required in respect of internal controls. The directors are typically well-intentioned – they want the best for the company and they genuinely believe that they have applied themselves to their duties with sufficient diligence – but their misunderstandings have led to them falling short in the discharge of their duties. We set out below some of the mistakenly-held beliefs that we have identified.

(a) We engage external auditors every year, so they will have checked our internal controls.

External auditors will not normally conduct an internal control review as part of their regular work in auditing an issuer's financial statements. An auditor may indicate that it will flag up any deficiencies that it identifies during its audit work, but that it is not the same as a dedicated and focussed review. Directors should not assume that their ongoing review of internal controls is satisfied by the absence of any red flags being brought to their attention, and should only expect an external auditor to conduct a formal internal controls review (in the sense of the Corporate Governance Code) if that has been specifically agreed as part of the services to be provided.

(b) We conduct reviews of internal controls every year, but we only check some controls / we check controls on a rotation (e.g. one-third of our controls are checked every three years).

The Corporate Governance Code makes clear that the annual review needs to cover all material controls. It may also be sensible to perform a "deeper dive" review into specific areas on an ad hoc or rotation basis. If professional advisers are retained to assist in a control review, the board must continue to maintain oversight, and ensure that the review is adequate.

(c) The internal controls are only the responsibility of the audit committee.

As noted above, whilst the audit committee has a particular role to play in respect of internal controls, all members of the board have responsibility for them. If the audit committee has been tasked to perform a lead role in respect of internal controls, then the other directors must at least continue to understand, support and oversee the audit committee's work, to take an active interest in any potential deficiencies, and to assist in the implementation of any necessary enhancements.

(d) The internal controls can be assumed to be sound if no major issues and/or red flags have emerged since the last review.

A passive approach to internal controls is insufficient to discharge duties. Even if no one has raised any concerns in respect of internal controls, that does not mean that there is no need for the board to continue to review and monitor them. Internal controls need to be considered on an ongoing basis to ensure that they are still fit for purpose by design, have been fully implemented, and are working effectively. The absence of any red flags in a given period may be attributable to luck, or may be the result of an environment in which concerns are not voiced or brought to the attention of the board.

(e) Even if there are internal control deficiencies, disciplinary sanctions are not appropriate if: (i) there was no loss suffered; or (ii) any loss suffered was not attributable to those deficiencies.

This is simply not correct. The purpose of a strong and effective internal control framework is to ensure risk is managed appropriately. If the internal controls are deficient, then the issuer and its investors may be exposed to untoward risk. This in itself may constitute a breach of duty which is worthy of disciplinary action and public sanction – it is not contingent on a loss being suffered.

In some more serious cases, a wrongdoer may have bypassed existing controls, and it may be argued that no level of internal controls could have stopped someone who is intent on malfeasance. However, that would also not be an excuse for failing to discharge duties.

Further guidance – what constitutes effective internal controls

Some individuals may not be certain what is required to ensure effective internal controls, particularly if they have not had the opportunity to see a comprehensive internal control framework operating in practice. There is, however, plenty of guidance and professional advice available to help.

The HKEX website has extensive information, guidance materials and e-learning, which can be found in the Listing Regulations section. These include the recently-published [Corporate Governance Guide for Boards and Directors](#).

Other materials which issuers and directors may find helpful include “[Internal Control and Risk Management – A Basic Framework](#)”, an introductory guide published by The Hong Kong Institute of Certified Public Accountants (HKICPA).

The HKICPA has also published (and recently updated) “[AATB 1 Assistance Options to New Applicants and Sponsors in connection with Internal Controls over Financial Reporting](#)”. This technical bulletin is targeted at new applicants for listing, but contains useful guidance for directors of issuers who are already listed. Amongst other things, it compares different approaches which could be adopted to assess a company’s internal controls. AATB 1 draws on and refers to “[Internal Control – Integrated Framework](#)”, produced by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission – a framework intended to enable companies to effectively and efficiently develop and maintain systems of internal control.

Appendix 3 of AATB 1 contains illustrative areas of focus for a review of internal controls, and lists out several categories relating to the controls at both:

- entity level: including control environment, risk assessment, control activities, information and communication monitoring; and
- process level: including sales/accounts receivable, procurement/accounts payable, inventory management, production, HR, fixed assets, cash/treasury management, insurance, financial reporting/disclosure, tax, and IT.

Whilst this is not intended to be a checklist, it may help to give some sense of the scope and depth of matters which a comprehensive internal control assessment needs to consider. Directors, and audit committees in particular, may find it helpful to review the categories in Appendix 3 and to reflect on whether the reviews being conducted in respect of their own company’s internal controls cover a sufficiently broad scope and go into sufficient detail, or whether the reviews could or should be enhanced.

If a director is at all unsure as to what is required for a robust and effective internal control and risk management framework, then he/she should consider obtaining professional advice.



Enforcement cases

Fourteen disciplinary sanctions were published between 1 July and 31 December 2021. The majority of these involve (i) failures by listed issuers and directors in relation to internal controls; and (ii) directors' failure to cooperate with the Exchange.

Internal controls

Our enforcement investigations invariably include consideration as to whether issuers have put in place effective systems and controls to support and achieve Listing Rule compliance. With this, we look at whether directors have taken sufficient and proactive steps to ensure such systems are implemented and operating effectively. We also consider the issuers' culture and attitude towards risk, compliance and corporate governance generally.

In the case of [China Fortune Investments \(Holding\) Limited](#), no systemic internal controls were implemented for a subsidiary of the Company. This enabled certain transactions to be carried out in an unauthorized manner

and undetected, which ultimately gave rise to the issuers' Listing Rule breaches. The issuer's directors failed to take any concrete steps to ensure there were adequate controls and supervision over the relevant subsidiary. Other examples of recent cases involving internal control deficiencies and relevant directors' breaches include [Winshine Science Company Limited](#), [Longrun Tea Group Company Limited](#), [Coolpad Group Limited](#), [Daisho Microline Holdings Limited](#) and [China Huiyuan Juice Group Limited](#).

Cooperation

As noted in our [Policy Statement](#), cooperation is one of our enforcement priorities. A failure to cooperate with the Exchange in our investigations will be viewed as serious misconduct.

The recent case examples of [Mr Wen Kai](#), [Mr Miguel Sun](#) and [Mr Luo Xi Zhi Peter](#) show that a failure to respond to the Exchange's enquiries will justify the imposition of a severe public sanction.



We set out below a summary of the sanctions published between 1 July and 31 December 2021. A full list of the Exchange's disciplinary sanctions can be found on the [HKEX website](#).

Date of news release	Issuer/name – summary of conduct
7 Jul 2021	<p>China Fortune Investments (Holding) Limited and nine directors</p> <ul style="list-style-type: none"> • Listed issuer's delay in (a) publishing its financial results and reports; and (b) announcing two discloseable transactions • Internal control deficiencies • Breach of directors' duties in relation to (a) the listed issuer's Listing Rule breaches and (b) internal control deficiencies • Two directors' breach of undertakings to cooperate with the Exchange's investigation
12 Jul 2021	<p>Winshine Science Company Limited and six directors</p> <ul style="list-style-type: none"> • Listed issuer's failure to (a) publish its financial results and reports in a timely manner; and (b) explain its deviation from the Corporate Governance Code • Internal control deficiencies • Breach of directors' duties in relation to (a) the listed issuer's Listing Rule breaches; (b) internal control deficiencies; (c) failure to act honestly and in good faith in the interests of the Company; (d) actions without proper purposes; and (e) conflicts of interest • Two directors' breach of undertakings to cooperate with the Exchange's investigation
14 Jul 2021	<p>Longrun Tea Group Company Limited and eight directors</p> <ul style="list-style-type: none"> • Listed issuer's (a) failure to comply with the procedural requirements applicable to major and connected transactions; (b) inaccurate, incomplete and misleading disclosure; (c) delay in publishing its financial results and reports; and (d) failure to explain its deviation from the Corporate Governance Code • Internal control deficiencies • Breach of directors' duties in relation to (a) the listed issuer's Listing Rule breaches; (b) internal control deficiencies; (c) failure to act honestly and in good faith in the interests of the listed issuer; (d) actions without proper purposes; and (e) conflicts of interest • Two directors' persistent and/or wilful failure to discharge their responsibilities under the Listing Rules
19 Jul 2021	<p>Mr Qian Gang and Mr Wang De Qun, former directors of Farnova Group Holdings Limited</p> <ul style="list-style-type: none"> • Breach of Listing Rules and directors' duties for dealing with the listed issuers' shares during two blackout periods without requisite notification and acknowledgment • Breach of undertakings to cooperate with the Exchange's investigation
17 Aug 2021	<p>Mr Wen Kai, former director of Winto Group (Holdings) Limited</p> <ul style="list-style-type: none"> • Breach of undertaking to cooperate with the Exchange's investigation
24 Aug 2021	<p>Coolpad Group Limited and six directors</p> <ul style="list-style-type: none"> • Listed issuer's failure to (a) comply with the procedural requirements applicable to advances to an entity and financial assistance; and (b) publish its financial results and reports in a timely manner • Internal control deficiencies • Breach of directors' duties in relation to (a) the listed issuer's Listing Rule breaches; (b) internal control deficiencies; (c) failure to act honestly and in good faith in the interests of the listed issuer; and (d) actions without proper purposes • Two directors' persistent and/or wilful failure to discharge their responsibilities under the Listing Rules • Two directors' breach of undertakings to cooperate with the Exchange's investigation

Date of news release	Issuer/name – summary of conduct
<u>2 Sep 2021</u>	<p>Mr Miguel Sun, former director of Grand Peace Group Holdings Limited</p> <ul style="list-style-type: none"> • Breach of undertaking to cooperate with the Exchange’s investigation
<u>11 Nov 2021</u>	<p>Daisho Microline Holdings Limited and one director</p> <ul style="list-style-type: none"> • Listed issuer’s inaccurate, incomplete and misleading disclosure • Internal control deficiencies • Breach of director’s duties in relation to (a) the listed issuer’s Listing Rule breaches; and (b) internal control deficiencies
<u>15 Nov 2021</u>	<p>China Ruifeng Renewable Energy Holdings Limited and one director</p> <ul style="list-style-type: none"> • Listed issuer’s failure to comply with the procedural requirements applicable to a major transaction • Breach of director’s duties in relation to the listed issuer’s Listing Rule breaches
<u>16 Nov 2021</u>	<p>Mr Luo Xi Zhi Peter, former director of China Fortune Holdings Limited</p> <ul style="list-style-type: none"> • Breach of undertaking to cooperate with the Exchange’s investigation
<u>17 Nov 2021</u>	<p>China Huiyuan Juice Group Limited (delisted) and seven directors</p> <ul style="list-style-type: none"> • Listed issuer’s failure to (a) comply with the procedural requirements applicable to advances to an entity and major and connected transactions; (b) publish its financial results and reports in a timely manner; and (c) explain its deviation from the Corporate Governance Code • Internal control deficiencies • Breach of director’s duties in relation to (a) the listed issuer’s Listing Rule breaches; (b) conflicts of interest; and (c) internal control deficiencies • One director’s persistent and/or wilful failure to discharge his responsibilities under the Listing Rules
<u>7 Dec 2021</u>	<p>Zhejiang Prospect Company Limited (delisted), ten directors and five supervisors</p> <ul style="list-style-type: none"> • Listed issuer’s failure to (a) publish numerous sets of financial results and reports; (b) comply with the procedural requirements applicable to advances to an entity and notifiable and connected transactions; (c) internal control deficiencies • Breach of directors’ duties in relation to (a) the listed issuer’s Listing Rule breaches; (b) internal control deficiencies; (c) failure to act in good faith in the interests of the listed issuer; (d) actions without proper purposes; (e) conflicts of interest; and (f) persistent failure to discharge their responsibilities under the Listing Rules • Two directors’ and all supervisors’ breach of undertakings to cooperate with the Exchange’s investigation
<u>9 Dec 2021</u>	<p>China U-Ton Future Space Industrial Group Holdings Limited (in Liquidation)</p> <ul style="list-style-type: none"> • Listed issuer’s failure to (a) announce the presentation of winding-up petitions against it; and (b) publish its financial results and reports in a timely manner
<u>16 Dec 2021</u>	<p>Bonny International Holding Limited and two directors</p> <ul style="list-style-type: none"> • Listed issuer’s failure to (a) comply with the procedural requirements applicable to advances to an entity and discloseable and connected transactions; and (b) consult its compliance advisor before entering into certain transactions • Breach of director’s duties in relation to (a) the listed issuer’s Listing Rule breaches; and (b) adequately safeguarding the Company’s assets