

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

28 August, 2014

Dear Sirs

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

We refer to your above Consultation Paper on Risk Management and Internal Control issued by the Exchange in June 2014.

The Institute of Internal Auditors Hong Kong Limited ("IIA HK") appreciates the opportunity to comment on the above Consultation Paper and the related proposed changes to the Hong Kong Corporate Governance Code ("the Code"). IIA HK is the Hong Kong Institute of The Institute of Internal Auditors ("IIA") which, as a globally recognized authority of the internal auditing profession, represents more than 180,000 members worldwide.

The IIA advocates that a properly structured internal audit function can provide independent, objective assurance and advisory activities that add value and improve an organization's operations. An adequately staffed and resourced internal audit function helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of governance, risk management and control processes.

Comments on the Exchange's Overall Approach

In today's rapidly changing political, economic and business environment, there is increasing focus on governance, risk, and control. Strong governance systems are necessary to ensure organizations meet their objectives and satisfy stakeholder expectations. Stakeholders expect boards and management to accept responsibility for implementing appropriate governance practices, putting them in the spotlight when it comes to the issue. In fulfilling its oversight responsibilities, the board looks to the internal audit function to provide assessments on the organization's governance practices.

Accordingly, the IIA HK supports fully the Exchange's initiative to upgrade Hong Kong's corporate governance framework. As the Exchange has stated in paragraph 3 of the Executive Summary to the Consultation Paper, "corporate governance codes, rules, and regulations in overseas jurisdictions have evolved....(and) the existing Code does not properly reflect this emphasis". In paragraph 24 of Chapter 1 of the Consultation Paper, it is stated that "the proposed amendments to the Code should bring the internal control section in line with existing market practices". We commend the Exchange for now taking this initiative to bring Hong Kong's corporate governance framework into line with global best practices and existing market practices, but this approach only brings Hong Kong's framework into line with those of overseas jurisdictions and only after a time lag for collation of information, evaluation thereof and formulating proposals for consultation before implementation.

Looking forward, we hope that regulations in Hong Kong can evolve faster, and lead, rather than play catch-up, to global best practices, in line with Hong Kong's own specific situation and circumstances and commensurate with Hong Kong's standing as a major financial centre which is recognised globally.

With regard to the approach to proposed additional disclosures, we agree that additional relevant information is beneficial to stakeholders. However, we have noticed a trend towards increasingly voluminous corporate and financial disclosure, with some annual reports presenting 100-plus pages of information. We believe the practice of presenting excessive amounts of highly generic disclosures, much of which is not specific to the reporting entity, will detract from the usefulness of relevant and insightful disclosures presented elsewhere in the annual report, especially for the many less professional retail investors in Hong Kong.

To address this concern, we recommend the adoption of a guiding principle of "conciseness" to corporate reporting, including the corporate governance report, emphasizing the need for sufficient context to understand the issues without being burdened with less relevant information. A good example of this approach to embedding conciseness as a guiding principle in corporate reporting is set out in the International Integrated Reporting Framework ("IIRF") issued on 9 December 2013 by the International Integrated Reporting Council ("IIRC").

Comments on the Specific Proposals

For ease of reference, we have structured our comments below in line with the sequencing of consultation questions set out in your Consultation Paper.

Q1. Risk Management and Internal Control

The IIA HK welcomes the increased emphasis on the impact of risk management on internal controls in your proposed revisions to the Code. However, we believe risk is most relevant in the context of the particular organization's business activities, its external environment and its approach as set out in its business model; these are necessary components to understand the risk appetite of and therefore the specific risks to a particular organization. Risk management is therefore only effective in the context of a robust approach to risk identification and evaluation which is specific to the organisation concerned. As the proposals focus on a new risk-based approach and given that risk is itself a complex area, we recommend that reference is given to the need for robust risk identification and evaluation in the context of the reporting entity prior to the application of related risk management methodologies and techniques.

A good example of a holistic approach to risk is set out in section 4D on Risks and Opportunities of the IIRF. The long term vision of the IIRC is a world in which integrated thinking is embedded within mainstream business practice in the public and private sectors, facilitated by periodic Integrated Reporting as the corporate reporting norm. Section 4B of the IIRF on Governance is also relevant as regards risk and controls, and sets out some very good high level strategic disclosure requirements.

A practical approach to addressing risk assessment is set out in a recent publication from The IIA published in November 2013 entitled "The Internal Auditor's Guide to Risk Assessment".

In view of the above, we recommend the use of a more general title of “Risk and Internal Control”, as the normal connotation is that it includes identification, evaluation and management of relevant material risk, rather than just risk management.

Q2. Responsibilities of the Board and Management

The IIA HK agrees with the proposed amendments to Principle C2 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.

Whilst the proposed CP 2.1 emphasizes the board’s responsibility to oversee risk management and internal controls on an ongoing basis, there is no guidance on the effective date for the review of effectiveness which should be performed at least annually. To provide consistency and avoid issuers choosing dates to their advantage, the wording should specify the effective date for the review to be the financial reporting year end date.

Q3. Disclosure in the Corporate Governance Report (“CGR”)

The IIA HK agrees with the proposal to introduce an amended RBP C2.6 to provide that the board disclose in the CGR that it has received assurance from management on the effectiveness of the issuer’s risk management and internal controls systems.

As both the proposed RBPs C2.6 and C2.7 are RBPs, we suggest that the word “may” be replaced by the word “should”.

In addition, as the proposed CP C2.1 already requires a review on effectiveness be conducted at least annually which is already disclosed in the CGR, if an issuer elects not to apply the proposed RBP C2.6 on disclosure in the CGR of management’s assurance on effectiveness, this may be perceived to be as a result of deficiencies in the risk management and internal control systems which are not disclosed. This uncertainty arising on related matters but separately dealt with as a CP and as a RBP is not ideal, and is further complicated by the proposed Mandatory Disclosure Requirement Q(c) which requires issuers to disclose “whether the issuer considers them (risk management and internal control systems) effective and adequate”.

Accordingly, we suggest that both the proposed RBPs C2.6 and C2.7 be incorporated as CPs in the new Code. These provisions are similar in objective to the management certification required under section 302 of The Sarbanes-Oxley Act, which has been applied for over 10 years now by many US listed companies.

Q4-12 Annual Review and Disclosure in the CGR

Subject to our comments above, we agree with the proposals as set out in Questions 4 to 12 of the Consultation Paper.

Q13-15 Internal Audit

The IIA HK supports fully the proposal to upgrade RBP C2.6 on Internal Audit Function to a full CP in the revised Code, and to add the sentence “The issuer should have an (effective) internal audit function”, with the addition of the word “effective”, which is also used in CP 3.6 of the UK Corporate Governance Code. The 2nd sentence of the proposed CP C2.5 would seem superfluous given the Code’s over-riding principle of “comply or explain”.

With regard to the meaning of “internal audit function”, we recommend this should align with the globally recognized definition of internal auditing as promulgated in The IIA’s International Professional Practices Framework (“IPPF”), and the following should be included in the Code or accompanying detailed guidance notes:

“Internal Audit Function refers to a department, division, team of consultants, or other practitioners that provides independent, objective assurance and consulting services designed to add value and improve an organization’s operations and accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes”.

As regards the revisions to the proposed CP C2.2, we recommend that CP C2.2 be amended with the addition of the underlined words, as follows“.

“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, which are relevant to the specific roles of these functions within the organization”.

Wording from the following 3 paragraphs could be incorporated into the Code or related detailed guidance notes to define internal audit functions’ scope of work and quality:

The internal audit function shall provide independent assurance to the Board (via the audit committee) and management regarding the organization’s corporate governance, risk management, and internal controls through general and specific audits, reviews, testing and other techniques deemed necessary to help protect assets, evaluate control effectiveness and efficiency, and evaluate compliance with policies and laws and regulations, among other things.

The head of internal audit (chief audit executive) is responsible for developing an annual risk-based internal audit plan that can be part of a multi-year plan. The chief audit executive takes into account audit risk factors as well as the organizational objectives and risk management framework, including using risk appetite levels set by management for the different activities or parts of the organization. The board’s approval of the audit plan implies that an appropriate budget will be available to support the internal audit function’s activities. The budget should be sufficiently flexible to adapt to variations in the internal audit plan in response to changes in the organization’s risk profile.

As to ensuring the high quality of internal audit functions, internal audit functions should follow globally recognized professional standards and other authoritative guidance. The only such globally recognized standards and guidance specifically for internal audit functions are The IIA’s IPPF. As part of the IPPF, the International Standards for the Professional Practices of Internal Auditing have been formally recognized by many national and global bodies including, amongst others, the US Federal Reserve and the Basel Committee on Banking Supervision. For example, the Board of Governors of the US Federal Reserve System (23 January 2013) in its supplemental policy statement on the internal audit function stated, “The Federal Reserve is providing this supplemental guidance to enhance regulated institutions’ internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance, including those issued by The IIA”.

Q16&17 Audit Committee's Role

Subject to our comments below, the IIA HK agrees with the proposals in respect of audit committees and their terms of reference, and that the matter of establishing separate risk committees should be left to issuers to decide in accordance with their own circumstances.

We recommend adding wording to include the responsibility of audit committees to appoint and terminate the chief audit executive. The audit committee's responsibilities may also include involvement in the performance evaluation of the chief audit executive.

Audit committees should also be responsible for overseeing execution of the annual internal audit plan. The chief audit executive should report regularly to the audit committee on the status of the plan. Best practices also suggest that both parties should meet periodically (no less than annually) in a private session without other members of management present to foster open and candid communications between internal audit and the audit committee.

Q18 Implementation Date

Given that the Consultation Paper itself states that "the proposed amendments to the Code should bring the internal control section in line with existing market practices" and on the assumption that the consultation conclusions can be issued in 2014, we consider that the new Code should be applicable to issuers in respect of the financial year ending 31 December 2015.

It would be our pleasure to answer any questions you may have, or discuss further our comments, in support of the Exchange's work in this area.

Yours sincerely
For and on behalf of
The Institute of Internal Auditors Hong Kong Limited



President