

Consultation Paper on Risk Management and Internal Control

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

On 20 June 2014 the HKEx published a Consultation Paper on Risk Management and Internal Control: Review of the Corporate Governance Code and Corporate Governance Report (the “**Consultation Paper**”). **We recommend that all companies listed on the Hong Kong Exchange consider the Consultation Paper as they will be affected.** The consultation period will close on 31 August 2014.

The proposals within the Consultation Paper aim to:

- Emphasise that internal controls are an integral part of risk management;
- Enhance accountability of the board, board committees and management by clearly defining their roles and responsibilities in relation to risk management and internal controls;
- Improve transparency of the issuer’s risk management and internal controls by upgrading the recommendation for issuers to disclose their policies and processes along with details of their annual review of the effectiveness of their risk management and internal control systems; and
- Strengthen oversight of issuers’ risk management and internal control systems by upgrading the recommendation for issuers to have an internal audit function.

The Consultation Paper is available on the HKEx website:
<http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201406.pdf>.

We have set out below our observations on the impact this consultation is likely to have on Hong Kong listed companies. Please note that our observations are based on the Consultation Paper, not the conclusions (which will be released after 31 August 2014) and that our summary below is not intended to be an exhaustive list of all proposed amendments:

Risk management and internal control:

It is the HKEx’s stated view that the current Corporate Governance code principles do not give sufficient weight to risks and risk management in relation to internal control, nor do they set out the relationships between the issuer’s objectives, the risks involved in achieving those objectives, and the internal control systems that mitigate those risks. ‘Risk management’ is likely to be incorporated into the internal controls section of the Corporate Governance code to reflect the domestic and international consensus that internal control is most effective when integrated with risk management.

This emphasis will likely encourage Hong Kong listed companies to adopt a structured approach to risk management that ensures the risks that threaten the company’s objectives are mitigated by internal control systems.

Responsibilities of the Board and Management:

It is likely to be clarified within the Corporate Governance Code that:

- The board is responsible for evaluating the risks it is willing to take in achieving the issuer's objectives and ensuring the establishment and maintenance of effective risk management and internal control systems.
- Management is responsible for designing, implementing and monitoring the risk management and internal control systems. Management should also provide assurance to the board on the effectiveness of the systems.

To meet these requirements, companies should consider adopting a structured approach to risk and control that incorporates the following:

- Risk and control as a regular boardroom agenda item,
- The company's risk appetite determined by the board,
- The identification and assessment of the most significant risks faced by the company,
- Identified risks mapped against mitigation, control and assurance activities,
- Senior management accountability for specific risk management and control activities, and
- Reporting of the above activities to the board for challenge and formal evaluation.

The HKEx makes reference to the Institute of Internal Auditors' 'three lines of defense' model as a guideline for companies when implementing their risk management and internal control framework. This model can also help companies to clarify responsibilities and accountabilities.

Annual Review and Disclosure:

An amendment is likely to clarify that the board has a responsibility to oversee the issuer's risk management and internal control systems on an ongoing basis, not as a one-off annual review.

There are likely to be numerous amendments to upgrade the current recommended disclosures to mandatory disclosures with regards to the adequacy of issuer's risk management and internal control systems. The minimum required information to be disclosed will be explicitly set out in order to facilitate comparability across issuers.

In practice, the emphasis on the ongoing nature of the board's oversight of risk management and internal control systems is likely to increase the regularity at which 'risk and control' is discussed at board level.

All HKEx listed companies will be required to revisit their disclosures to ensure that they comply with the new disclosure requirements. This will have a greater impact on companies that do not currently comply with the RBP disclosures.

Internal Audit:

It is currently recommended best practice for issuers without an internal audit function to review the need for one on an annual basis and disclose the outcome of this review in the Corporate Governance Report. This is likely to be upgraded to a Code Provision (i.e. subject to 'comply or explain') and amended to state that issuers should have an internal audit function, and those without should review the need for one and disclose the reasons in the Corporate Governance Report on an annual basis.

The Corporate Governance code is likely to clarify that 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.

The Corporate Governance code is likely to state that the internal audit function may be outsourced and that a group with multiple listed issuers may share group resources of the holding company to carry out the internal audit function for the group.

The board will be expected to ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the internal audit function.

The HKEx estimates that 49% of HKEx listed companies may not have an internal audit function. Under the proposed amendments, these companies will have to review the need for an internal audit function (either in-house or outsourced). Ensuring the adequacy of the internal audit function will be the explicit responsibility of the board.

Boards of companies with an internal audit function are expected to ensure that internal audit's activities are mapped against the board's priorities regarding risk and control to ensure adequate coverage.

The Audit Committee's Role:

Review of the issuer's financial controls, internal controls and risk management systems is already the responsibility of the audit committee. It is likely that the relevant sections of the Corporate Governance Code will be updated for consistency in wording, with no substantial change in responsibility.

The decision whether to establish a separate board risk committee is likely to be left to companies to decide for themselves.

The main impact on the audit committee is likely to be to provide oversight with regards to the implementation of the amendments that have previously been discussed.

If you have any questions or would like more information, please contact:

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