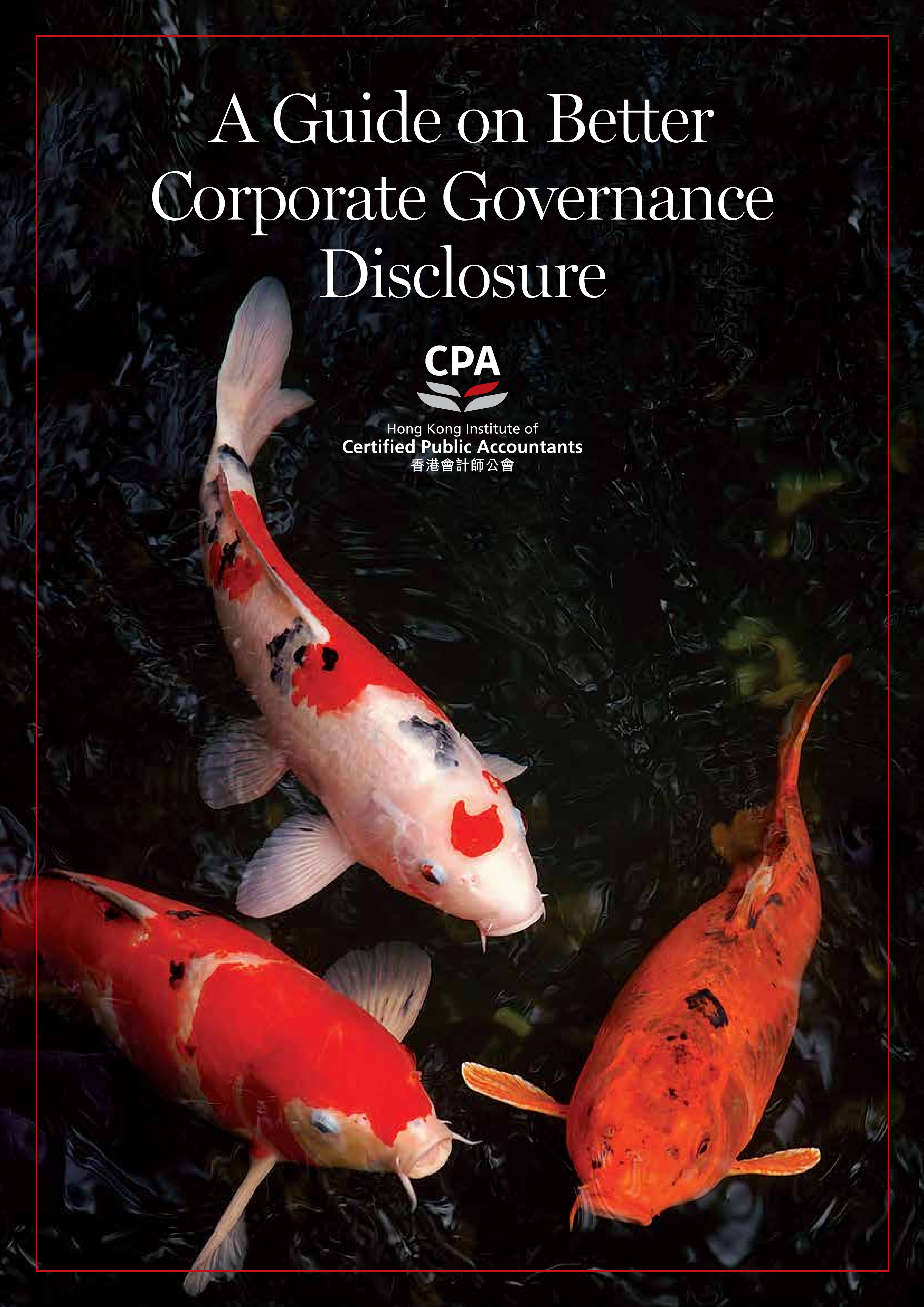
A Guide on Better Corporate Governance Disclosure

Hong Kong Institute of
Certified Public Accountants
香港會計師公會



The Institute would like to thank the convenor, deputy convenor and members of the Corporate Governance Working Group of the Professional Accountants in Business Leadership Panel, for their work on the development and promotion of this guide, and the Panel for its direction and support on this project.

COMPOSITION OF THE CORPORATE GOVERNANCE WORKING GROUP

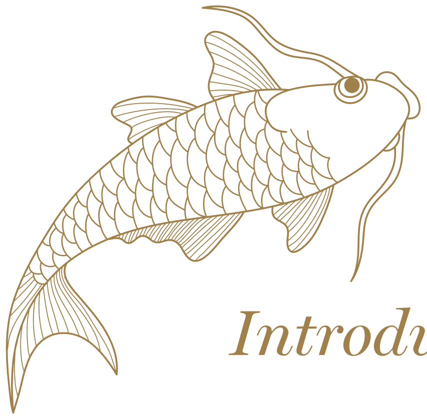
Convenor:	Kim Man Wong	HK Electric Investments Limited
Deputy convenor:	Wendy Yung	Hysan Development Company Limited
Members:	Derek Broadley	Deloitte Touche Tohmatsu
	Clara Chin	Hospital Authority
	Eddie Kam	Getnice Holdings Limited
	Stephen Law	MTR Corporation Limited
	Guy Look	Sa Sa International Holdings Limited
	Horace Ma	Kong Tai Sundry Goods Company Limited
	Patrick Rozario	BDO Financial Services Limited
Secretaries:	Peter Tisman	Director, Specialist Practices, HKICPA
	Sharon Yeung	Associate Director, Specialist Practices, HKICPA

COMPOSITION OF THE INSTITUTE'S 2013 PROFESSIONAL ACCOUNTANTS IN BUSINESS LEADERSHIP PANEL

Chairman:	Kim Man Wong	HK Electric Investments Limited
Deputy chairman:	Stephen Law	MTR Corporation Limited
Members:	Derek Broadley	Deloitte Touche Tohmatsu
	Stephen Chan	Trinity-C Management Limited
	Jennifer Cheung	The Hongkong and Shanghai Banking Corporation Limited
	Cavan Cheung	Hong Kong Cyberport Management Company Limited
	Clara Chin	Hospital Authority
	Susanna Chiu	Li & Fung Development (China) Limited
	Ronald Fan	The Treasury
	Eric Fok	Bright Talent Consultants Limited
	Kantstant Fung	Sun Life Finance Hong Kong
	Eddie Kam	Getnice Holdings Limited
	Vivian Lau	Fortune Sun (China) Holdings Limited
	William Lo	Airport Authority Hong Kong
	Guy Look	Sa Sa International Holdings Limited
	Horace Ma	Kong Tai Sundry Goods Company Limited
	Anthony Ng	Fubon Bank (Hong Kong) Limited
	Patrick Rozario	BDO Financial Services Limited
	Simon Wong	Legend Capital Partners Inc.
	Wendy Yung	Hysan Development Company Limited
Secretaries:	Peter Tisman	Director, Specialist Practices, HKICPA
	Sharon Yeung	Associate Director, Specialist Practices, HKICPA

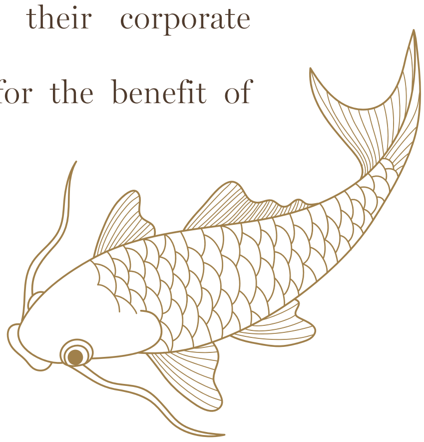
The Institute also acknowledges those companies whose annual reports provided the examples of good corporate governance disclosure used in this guide.

CONTENTS



Introduction

The main aim of this guide, ***A Guide on Better Corporate Governance Disclosure***, is to encourage meaningful corporate governance disclosures by Hong Kong-listed companies, under the revised Corporate Governance Code of the stock exchange listing rules (“revised Code”)[1], which took effect in 2012. It may also be of value to other companies and organisations that wish to enhance their corporate governance disclosures for the benefit of their stakeholders.



[1] *Appendix 14 to the Main Board and Appendix 15 to the Growth Enterprise Market listing rules*

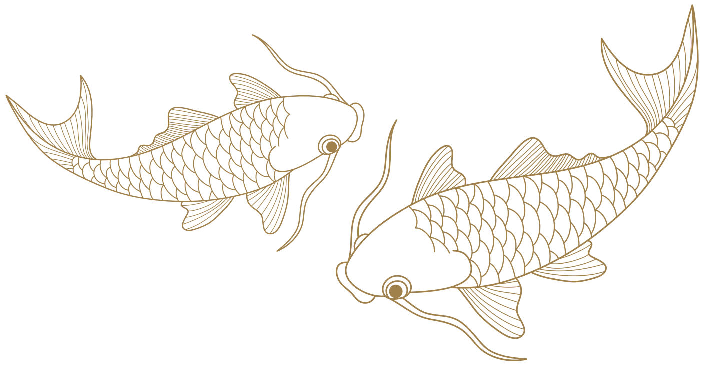
Background

The Hong Kong Institute of CPAs ("Institute") has been a prime mover in advocating good corporate governance in Hong Kong for the past two decades. The Institute has always believed that sound, well-organised and well-regulated markets and good corporate governance are vital ingredients in Hong Kong's success as a financial centre and will remain so in the future.

Between 1995 and 2008, the Institute published a series of corporate governance guides and surveys on a range of important topics, including audit committees, directors' remuneration, internal control and risk management and public sector governance. In 2000, the Institute expanded its work in this area by establishing the Best Corporate Governance Disclosure Awards, to promote awareness of good corporate governance and to give recognition to exemplars of best practice in the Hong Kong market.

One of the Institute's main corporate governance guides, published in 2001, *Corporate Governance Disclosure in Annual Reports - A guide to current requirements and recommendations for enhancement* ("2001 guide") reviewed disclosure in annual reports, setting out the requirements applicable at that time and making a number of recommendations for strengthening corporate governance disclosure. This was a forward-looking document, containing, as its core recommendation for enhancement, a proposal that listed and public companies be encouraged to include a statement on corporate governance in their annual reports. The inclusion of such a statement is now seen as a basic requirement of good governance. Part of the preamble to the 2001 guide bears repeating, remaining as true today as it was then:

A strong disclosure regime is a pivotal feature of market-based monitoring of corporate conduct and is central to the ability of shareholders to exercise their voting rights effectively. Experience in countries with large and active equity markets shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in capital markets. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management and make informed decisions about the valuation, ownership and voting of shares. Insufficient or



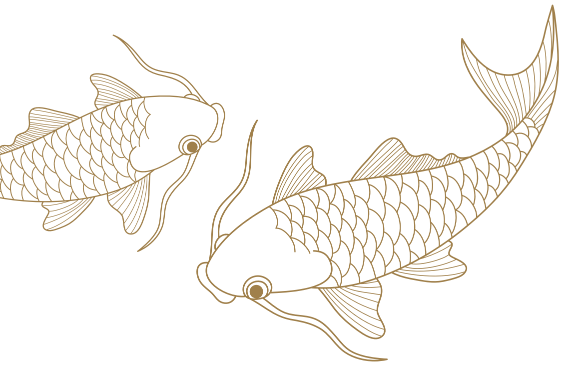
unclear information may hamper the ability of markets to function, may increase the cost of capital and result in a poor allocation of resources.

Disclosure also helps improve public understanding of the structure and activities of companies, their policies and performance with respect to environmental and ethical standards and their relationships with the communities in which they operate.

At the time of the publication of the 2001 guide, mandatory corporate governance disclosures in Hong Kong were quite limited. The Code of Best Practice at Appendix 14 of the listing rules was a sparse document by today's standards. In 2004, it was replaced by a much more substantial Code on Corporate Governance Practices and set of disclosure requirements in the Corporate Governance Report ("CGR"). Listed companies were expected to apply the "provisions" of the 2004 Code on a "comply or explain" basis. The Code also contained "principles", setting out the underlying aims of each main section, and recommended best practices ("RBPs"), compliance with which was entirely voluntary. The CGR, meanwhile, contained mandatory and recommended disclosures. This framework took effect, for new accounting periods, as from 1 January 2005, except for the Code provisions and disclosures relating to internal control, which became effective as from 1 July 2005. During the intervening period, the Institute published guidance on internal control, at the invitation of the Hong Kong Stock Exchange.

In 2011, the 2004 framework underwent another substantial review, consultation and revision, in the light of developments over the previous seven years. As a result of this exercise, a number of RBPs were elevated into Code provisions and some provisions became listing rules. The Code and the CGR were also combined into a single, expanded revised Code. Other than the new listing rule requirement that independent non-executive directors must form at least one third of the board, for which the deadline was 31 December 2012, the changes contained in the revised Code were implemented, on either 1 January or 1 April 2012.

Notwithstanding the development over the years of a much more extensive framework of rules, requirements and recommendations, the Institute's professional accountants in business leadership panel ("PAIBLP") perceived there to be scope to produce additional guidance for listed companies,



to discourage a "box ticking" approach and to encourage more meaningful disclosure in annual reports. The PAIBLP set up a corporate governance working group with members from diverse backgrounds to develop suitable guidance.

Some elements of the revised Code are fairly straightforward and need no further explanation, such as disclosure of the number of board and committee meetings held during the year and directors' attendance records. However, other important areas are not as self-explanatory, such as the requirement for an annual review of internal controls to be conducted and how this should be implemented. The purpose of this guide is to help bridge that gap. As first step, we believe that helping preparers to appreciate the underlying rationale of the Code principles and provisions would encourage more informative and useful disclosure, which can be achieved without having to divulge commercially-sensitive information. The guide seeks to identify and summarise the key points through a series of themes. It also uses real examples, extracted from annual reports, including some from award winners in the Institute's Best Corporate Governance Disclosure Awards, to illustrate and give life to the issues.

The guide focuses on significant areas of the revised Code, where, we believe, more meaningful disclosure would be welcomed by investors and other stakeholders. The areas covered, initially, are the (i) board, (ii) internal controls, (iii) audit committee and (iv) communication with shareholders. This is not intended to be a static, one-off exercise but, rather, something that can be further expanded and refined over time.

Enhancing corporate governance disclosure is a continuing and interactive process. In preparing this guide, feedback was sought from annual report preparers, as well as users such as investors, independent directors, listed company management, auditors and consultants. We are grateful for their perspectives.

We hope that this guide will provide a useful, practical tool for, members of the Institute who have responsibilities for corporate governance within their companies, and also for the boards and managements of companies which seek to maintain high standards of corporate governance disclosures or to improve their disclosures.

The Institute welcomes further feedback and suggestions in relation to this guide. Please send any views to hkicpa@hkicpa.org.hk.

Part 1
The Board:

Role, what it did during the year and how

Summary of relevant sections of the Corporate Governance Code ("Code") (Appendix 14 Main Board and Appendix 15 Growth Enterprise Market Listing Rules)

Code Section A.1 – The Board: Principle

An issuer should be headed by an **effective board** which should assume responsibility for its **leadership** and **control** and be collectively responsible for promoting its success by **directing** and **supervising** its affairs. Directors should take decisions objectively in the best interests of the issuer.

- **Code Provisions**:

There are detailed **Code Provisions under the above Principle**, prescribing (i) elements of the board process, including frequency of board meetings, the setting of the agenda, preparation of minutes, and the need for physical meetings (rather than written resolutions) in conflict of interest situations; (ii) procedure enabling board members to seek independent professional advice; (iii) appropriate insurance arrangements for directors (A.1.1 - A.1.8).

- **Corporate Governance Report** ("CG Report"):

An issuer's CG Report must include a narrative statement explaining **how** the issuer has **applied** the **Principles** in the Code, enabling its shareholders to evaluate how the principles have been applied (G.(a)). In addition, various, more specific, disclosures are required, e.g., number of board meetings held during the year (I.(b)), attendance by directors at board and general meetings (I.(c)) and a statement of the board's and management's respective responsibilities and accountabilities (I.(e)).

1. Analysis: Key themes underlying the Code requirements

1.1 Under **the Code Principle in section A.1**, two aspects of the board's leadership role are stressed.

Firstly, "**directing**" the affairs of the company; secondly, "**supervising**" the same. The "**directing**" role is a broad concept, which is interpreted to encompass, among other things, **setting the issuer's strategic aims**, and ensuring (including by way of establishing appropriate policies) that the necessary financial and human resources are in place for the issuer to meet its objectives and implement the agreed strategies. Meanwhile, the "**supervisory**" aspect seems to refer to the board's role in **monitoring the performance of management**.

1.2 In addition, some specific responsibilities of the board are elaborated **elsewhere in the Code** – including, determination of remuneration, financial reporting, internal controls and risk management, corporate governance, and communications with shareholders. (The Appendix sets out, in the form of a chart, various aspects of the board and its work, as addressed in other Code Principles.)

1.3 Under the above Code Principle, there are detailed **Code Provisions** setting out aspects of the **board process**. Underlying these is the **effective and active participation by board members together**. They must also **work together collectively**. How does the board process facilitate their working together?

1.4 It is important to note that the concept of **directors' collective responsibility** for the company and their duties as directors are addressed under other Listing Rules:

For example: Rule 3.08: "The **board** of directors of an issuer is **collectively responsible** for its management and operations. The Exchange expects the directors, both collectively and individually, to fulfil **fiduciary duties** and **duties of skills, care and diligence** to a standard at least commensurate with the standard established by Hong Kong law..." [emphasis added]

1.5 To sum up, our interpretation of the key themes underlying the Code Principle in section A.1 are:

A. The board's key roles are setting the issuer's strategy and monitoring the management's performance.

B. A good board process facilitates the operation of the board.

1.6 In addition, report users, including investors, would be interested in understanding, in broad but clear terms:

C. The board's work during the year and how it is linked to the issuer's strategy and focus.

2. A closely-related topic is board effectiveness (addressed under other Code Principles)

2.1 A discussion on the board's roles is inevitably linked to other aspects of the board. (The Appendix gives an overview of the various topics.) The board's **effectiveness**, in particular, is relevant. Report users would want to see that the board has the appropriate skills and balance to discharge its duties:

- The board should have the appropriate **balance of skills, experience and diversity** of perspectives to enable it to discharge its duties and responsibilities effectively. (See the Code Principle under section A.3 of the Code – Board composition.)

- **Board independence** (Code Principle, section A.3) generally, is an area of investor focus, particularly in the context of family-controlled companies in Hong Kong. What steps have been taken to ensure board independence? Issuers may have taken different paths, in light of their own circumstances; for example, voluntarily adopting a schedule of significant matters that require independent director approval.

- There should be a formal, considered and transparent procedure for the **appointment of new directors** (and re-appointment of existing directors) to the board. (See the Code Principle under section A.4 – Appointments, re-election and removal.)

- **Board succession** is also an area of investor focus in Hong Kong, in the context of family-controlled companies. (See the Code Principle under section A.4.)

2.2 Board evaluation

- Board evaluation should also help to ensure the effectiveness of a board. Currently, it is a **Recommended Best Practice** ("RBP") under the Code (B.1.9) that the board should conduct a regular evaluation of its performance. It is, however, a widely accepted international best practice.

- For example, under the Corporate Governance Code in the United Kingdom ("UK"), board evaluations should consider the balance of skills, experience, independence and knowledge of the company reflected on the board, its diversity, and how the board works together. Individual director performance, in terms of contribution and commitment, should also be covered. The issuer should then act on the results of the evaluation by recognising the strengths and weaknesses of the board. The relevant part of the annual report should explain how the performance evaluation has been conducted. (See UK Corporate Governance Code - Main Principle B.6.)

3. How to provide meaningful disclosure in relation to the key themes

This section considers what disclosure in an issuer's report, users, including investors, would consider "meaningful". **It is possible to disclose useful information while providing reasonably high-level statements**, without having to divulge commercially-sensitive information.

Under each theme, we have included **brief commentary** and also **examples** to illustrate and highlight the relevant issues, where appropriate.

Theme A: The board's key roles are setting the issuer's strategy and monitoring the management's performance.

The board has **two key roles**: that of setting strategy and monitoring management performance. How does the board **work with management** in performing these two roles, particularly in setting strategy?

Pursuant to these two broad roles, what are **the board's specific responsibilities**? How did the board reach an understanding on this? Some boards may set out a **formal board mandate**. As we have seen in the earlier section, some specific responsibilities of the board are expressly stipulated elsewhere in the Code (e.g., internal controls and risk management (see Code Principle and Provisions, section C.2)). In addition to these, are there any other specific responsibilities of the board? For instance, corporate values and ethics are also crucial in building success and avoiding failure. Does the board set the right tone at the top?

Theme A: Example

The following company clearly sets out the board's roles and responsibilities:

The Board's role is to provide leadership of the Company and direction for management. It is collectively responsible and accountable to the Company's shareholders and stakeholders for the long term success of the Group. While the management is delegated to run the Group's day-to-day business (as more specifically described on page •), the Board focuses on and reserves powers in the most significant matters of the Group, including:

- formulating long and short term strategic directions of the Group, including development strategy, major investments, acquisitions and disposal of major assets;
- preparing and approving financial statements, annual and interim reports, and making judgements that are fair and reasonable in the preparation of the Company's disclosure statements;
- approving the Group's annual budgets and forecasts;
- approving changes in accounting policies;
- approving changes to the Company's capital structure;
- setting dividend policy;
- authorising material borrowings and expenditures;
- approving the appointment of Directors for election and/or re-election in general meetings;
- performing corporate governance functions in accordance with the CG Code, including determining the Group's corporate governance policies, and reviewing and monitoring the corporate governance practices of the Group; and
- overseeing and reviewing the effectiveness of the risk management and internal control systems of the Group through review of reports from Audit Committee and the Group Management Committee

(The Hongkong and Shanghai Hotels, Limited, Annual Report 2012)

Theme B: A good board process facilitates the operation of the board.

Apart from understanding the board's roles and responsibilities, report users would like to understand how the board is working together to achieve these. Is the board working together effectively? A good board process will greatly facilitate the board's working. What steps have been taken, for instance, to facilitate constructive discussions?

Theme B: Example

The following international example addresses how various aspects of the board process help to facilitate board functioning – ranging from setting of agenda, provision of information, and a general focus on constructive debates and discussions. Feedback from board evaluation also helped in further enhancing the board process:

> The Board agenda focuses on our themes of driving our strategy, developing strong leadership and succession, monitoring execution, protecting our trusted brand and our strong relationships with customers, employees and other stakeholders.
>
> While we recognise the importance of compliance, we try to avoid spending time on box-ticking and gold-plating legislation, choosing instead to focus on the long-term plans for our business and its execution.
>
> Following our external Board evaluation last year, we further reviewed all information sent to Board members. We also moved to electronic distribution of our Board papers by iPad – a contribution, albeit small, towards supporting our Plan A objective to reduce the use of printed paper across our business, but one which clearly demonstrates the Board's willingness to embrace new technology and more efficient methods of communication.
>
> Our Board agendas today allow more time for debate and long-term strategic discussion, with two Board away-days held during the year. Our forward planner gives Board members visibility of what is on future agendas for their consideration. We also schedule time during every meeting for ad hoc feedback as well as giving the non-executive directors an opportunity for private discussion.

(Marks and Spencer Group plc, Annual Report 2012)

Theme C: The board's work during the year and how it is linked to the issuer's strategy and focus.

Apart from understanding the roles and responsibilities of the issuer's board in general terms, report users would be interested in knowing about the linkages to the issuer's strategy and objectives during the year. **What were the board's objectives during the year? Have these changed from previous years?**

Issuers need to find a **balance** between making **meaningful disclosures and safeguarding commercial sensitivity**. The example below shows how **fairly high-level statements** can be used to bring out meaningful information, without divulging commercially-sensitive information.

The description of the board's work in the annual report is an important section and should be reviewed by the board thoroughly before publication.

Theme C: Example – Roles of the board and focus during the year

In this example, the roles of the board are set out – being strategic planning, internal controls and risk management, culture and values, capital management, corporate governance, and board succession. The specific actions taken by the board during the year under various key headings are then specifically listed.

What the Board has done during 2011

During the year, 4 Board meetings were held. The focus of these meetings included the following topics of discussion and yielded the following results:

1. Leadership

- appointment of Non-executive Chairman
- appointments of new Board members who bring new insights to the Board
- reviewed composition of Board Committees

2. Strategy

- reviewed strategic plans for the Group's core leasing (Office, Retail, and Residential segments) to meet short-term objectives and to strengthen medium-term competitiveness
- ongoing assessment of Hysan Place project, with a view to enabling it to take the Group to another level of commercial success and sustainability
- reviewed the positioning of our core property portfolio in Causeway Bay as a choice location for work and play; and management's plan to further strengthen its branding and marketing
- reviewed further opportunities in our core property portfolio with management

Roles of Board

- Strategic Planning
- Internal Controls and Risk Management
- Culture and Values
- Capital Management
- Corporate Governance
- Board Succession

3. Risk Management

- Audit Committee received presentation on best practices in risk management and endorsed management's plans to further strengthen the risk identification and assessment process, and to adopt more frequent and structured reporting to the Audit Committee and the Board
- assessed effectiveness of financial controls, and other internal controls (Please refer to separate "Internal Controls and Risk Management Report")
- legal and regulatory compliance added as standing item for each Board meeting

4. Relations with Shareholders

- investor relations added as standing item for each Board meeting
- investor relations reports describing investor and analyst opinions are provided regularly to the Board
- enhanced investor relations programme to expand coverage by analysts

(Hysan Development Company Limited, Annual Report 2011)

Appendix

Overview of CG Principles applicable to the board

Effectiveness
- Board composition (Code Principle, A.3)
- Appointment, re-election and removal (Code Principle, A.4)
- Nomination Committee (Code Principle, A.5)
- Board evaluation (Recommended Best Practice, B.1.9)

Board Leadership
- Board's role (Code Principle, A.1)
- Chairman and chief executive (Code Principle, A.2)
- Functions of non-executive directors "NEDs"
  - including exercise of independent judgment; scrutinising performance (Provision, A.6.2)

Responsibilities of Directors (particularly NEDs)
(Code Principle, A.6)
- Functions of NEDs (Provision, A.6.2)
- Time and commitment (Provision, A.6.3)

Delegation by Board: Board and Management
- Formal schedule of matters reserved for full board decision (Code Principle, D.1)
- Respective responsibilities, accountability and contributions (Provision, D.1.3)

The board
- Under the Corporate Governance Code

Delegation by Board: Board committees
- Written terms and reference (Code Principle, D.2)
- Report back to the board (Provision, D.2.2)

Induction, Training, Supply and Access to Information
- New director induction (Provision, A.6.1)
- Continuous professional development (Provision, A.6.5)
- Facilitate informed board decision – making informed decision and discharge of responsibilities (Code Principle, A.7)
- Timely information in appropriate form and quality (Code Principle, A.7)

Special Responsibilities of the board covered in the Code

Company Secretary
(Code Principle, F)
- Important role in supporting the board

Remuneration
- Disclosure of policy, level, make-up and relevant procedure (Code Principle, B.1)
- Determination by remuneration committee under delegated authority or by the board (Provision, B.1.2)

Audit and Accountability
(Code Principles, C.1 and C.2)
- Financial reporting
- Internal controls and risk management

Corporate Governance
- Performed by the board or a committee (Provision, D.3.2)

Communications with Shareholders
(Code Principle, E.1)
- Ongoing dialogue with shareholders
- Particular emphasis on annual general meetings

This chart gives an overview of various areas of the Code applicable to the board, setting the context for discussion of board roles.
(N.B. Areas seen as particularly relevant to board roles are highlighted in red)

Part 2
Accountability and Audit:
Internal Controls - Sound and effective controls

Summary of the relevant sections of the Corporate Governance Code ("Code") (Appendix 14 Main Board and Appendix 15 Growth Enterprise Market Listing Rules)

Code Section C.2 - Internal Control: Principle

The board should ensure that the issuer **maintains sound and effective internal controls** to safeguard shareholders' investment and the issuer's assets.

- **Relevant Code Provisions** are (emphasis added):

C.2.1: **The directors** should **at least annually** conduct a **review of the effectiveness** of the issuer's and its subsidiaries' **internal control** systems and **report to the shareholders that they have done so** in their Corporate Governance Report. The review should cover all material controls, including **financial, operational** and **compliance controls** and **risk management functions**.

C.2.2: The board's annual review should, in particular, consider the **adequacy** of resources, staff qualifications and experience, training programmes and budget of the issuer's **accounting and financial reporting function**...

- There are also **Recommended Best Practices ("RBPs")** (C.2.3) regarding, inter alia:

  (i) Factors that the board's **annual review** should consider, including:

    (a) the scope and quality of **management's ongoing monitoring of risks** and of the **internal control** system, and where applicable, the work of **internal audit and other assurance providers**;

    (b) the extent and frequency of **communicating monitoring results to the board** (or board committees) to enable it to **assess the issuer's controls and the effectiveness of risk management**;

    (c) **significant control failings or weaknesses identified** during the period **and their impact, or potential impact, on the issuer's financial performance or condition.**

(ii) **Corporate governance report ("CG Report")**: issuers should disclose in the CG Report <u>**how**</u> they have complied with the Code Provisions on internal control during the period, including (C.2.4):

  (a) the **process** used to **identify, evaluate and manage significant risks**;

  (b) an **acknowledgement by the board that it is responsible for the internal control system and reviewing its effectiveness**;

  (c) the **process used to review the effectiveness** of the internal control system, and

  (d) the **process used to resolve internal controls defects** for any significant problems disclosed in its annual reports and accounts.

(iii) **Issuers without an internal audit function should review the need for such function, on an annual basis**, and should disclose the outcome in the CG Report.

- The above disclosures should provide **meaningful information** and should **not** give a **misleading** impression (C.2.5).

- There are also a number of other "**recommended disclosures**" in the **CG Report** regarding internal controls, including procedures and **internal controls** for the handling and **dissemination of inside information** (S.(a)(ii)) and the **criteria** used **for assessing the effectiveness of the system** (S.(a)(vii)).

1. Analysis: Key themes underlying the Code requirements

1.1 The **Code Provisions** do **not prescribe** any **internal controls system** applicable to all issuers. The intention is that issuers should have a free hand to design their systems, having regard to any special circumstances that may lead to their adopting a particular approach.

1.2 Again, the Code Provisions do **not prescribe** the **elements of the board's review** process or rigid requirements as to **disclosure**. Some **guidance** is, however, provided in the form of "**RBPs**".

1.3 Relationship between **internal controls and risk management**:

A useful summary is contained in the UK Turnbull Guidelines:

"...a company's internal controls system has a key role in the management of risks that are significant to the fulfilment of its business objectives... A company's objectives, its internal organisation and environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks..."

The RBPs reflect significant risk management disclosure considerations, e.g., disclosure of the process used to identify, evaluate, and manage significant risks.

1.4 At the invitation of the Stock Exchange, in 2005, the Hong Kong Institute of Certified Public Accountants ("Institute") published a guide entitled "*Internal Control and Risk Management – a Basic Framework*" ("**Implementation Guide**").

1.5 The guide aimed to help listed issuers **understand** and **implement** the requirements in the **Code**, and to **devise their own internal controls procedures**.

Therefore, in discussing disclosure issues in this document, where appropriate, reference will be made to the Implementation Guide as well, and to the underlying principles set out therein.

1.6 To sum up, our interpretation of the key themes underlying the Code requirements (and RBPs) are:

A. The issuer has to maintain a sound internal controls system.

B. The board is responsible for the issuer's maintaining a sound internal controls system and should acknowledge this in the CG Report.

C. The board has to review the system's effectiveness and report to the shareholders at least on an annual basis.

It should obtain the necessary assurance from other stakeholders, including management's on-going monitoring, the work of (where applicable) internal audit and other assurance providers (e.g., external auditors).

(N.B. This board review process should involve on-going monitoring, not simply a review to be conducted annually.)

1.7 Report users, including investors, would also appreciate:

D. A high-level description of key risks facing the company, their impact and the mitigating measures taken.

2. How to provide meaningful disclosure in relation to the key themes

This section considers what disclosures users of an issuer's report, including investors, would consider **"meaningful" and to offer practical value. It is possible to provide meaningful disclosures by using high-level statements**, without divulging commercially-sensitive information.

Under each principle, we have included some brief **commentary**. In some cases, there are **sub-themes** under the relevant theme. **Examples** are also provided to illustrate the relevant issues where appropriate.

(N.B. Theme B is not discussed in detail as it involves only a straightforward statement of board responsibility).

Themes A and B: The issuer has to maintain a sound internal control system. The board is responsible for the issuer's maintaining a sound internal controls system and should acknowledge this in the CG Report.

There are various key elements of a "sound internal control system", which can be described in terms of possible sub-themes.

Sub-theme (A.1): Responsibilities

Under the Code, the **board has overall responsibility** for the issuer's internal controls and risk management system. However, it is the role of **management** to implement the board's policies on risk and control, i.e., to design, operate, and monitor a suitable system. The board may also delegate detailed aspects of the review work to **board committees** (e.g., audit committee, risk management committee). Relevant **considerations** include the size and composition of the board; the scale, diversity, and complexity of the company's operations; and the nature of the significant risks it faces. If a designated committee has a special role in supporting the board in this aspect, the results of its work should be reported to the board.

Under a widely accepted model, there are **three lines of defence** below the board and senior management levels: (a) operational managers who own and practise the controls on a day-to-day basis; (b) risk, compliance and other policy setting groups which help build and monitor the first line of defence; and (c) internal audit which provides independent assurance.

So, how does the process work in your company?

Sub-theme (A.2): State the structured approach adopted

The adoption of a structured approach, i.e., a well-defined and systematic framework in applying internal control principles, will greatly assist report users to appreciate the underlying rigour of the system. It also facilitates the work of the board in reviewing it. It is useful, therefore, to state the approach adopted.

One well-known framework is that published by the Committee of Sponsoring Organisations of the Treadway Commission ("**COSO**") in the United States. This approach is the principal framework referred to in the Implementation Guide and it is consistent with the approach suggested by Hong Kong Standard on Auditing 315. The COSO framework has five key components:

- **Control environment**
- **Risk assessment**
- **Control activities**
- **Information and communication**
- **Monitoring activities**

(It should be noted that the original COSO framework, published in 1992, was updated in 2013 ("**COSO 2013**"). The revisions involved, among other things, codifying 17 principles that support the five components above. After December 15, 2014, compliance with the original framework will no longer be regarded as complying with COSO and the updated framework will be considered the sole COSO internal control mechanism).

Sub-theme (A.3): Describe key aspects of your company's own internal control system

As explained in the Implementation Guide, internal controls **should be tailored to an individual company's particular characteristics and circumstances**. This may depend upon, for example, its industry, size, and organisational structure. Therefore, report users would be interested in understanding the key aspects of your company's system in light of your own circumstances.

There are detailed discussions in the Implementation Guide on the five components under the COSO model.

Theme A: Examples – sub-theme (A.3): A company's internal controls system (risk management aspects)

Example 1

A key component of a company's internal control system is risk management. The following example describes the tools and processes used. The integration of risk in strategic development, business planning and other key business processes, is stressed. (Also see example for sub-theme (A.4) – "improvement areas and the way forward" below):

Our Risk Management Process

- **Is embedded in our strategy development, business planning, investment decisions, capital allocation and day-to-day operations.**
- **Is in line with leading industry standards and practices, including ISO 31000 : 2009 Risk Management - Principles and Guidelines.**
- **Involves establishing the context, identifying risks, assessing their consequences and likelihood, evaluating risk levels, control gaps and priorities, and developing control and mitigation plans. This is a continuous process with periodic monitoring and review in place.**

Our Quarterly Risk Review Process at Group Level	• Every quarter, our business and functional units are required to submit their material risks identified through their risk management process to Group Risk Management. • Group Risk Management, through aggregation, filtering and prioritizing processes, compiles a Quarterly Group Risk Management Report for discussion at the Group Executive Committee (GEC), chaired by the CEO. The Committee reviews and scrutinizes the material risks and ensures the appropriate controls and mitigation measures are in place or in progress. Emerging risks, which might have a material impact on the Group over a longer timeframe, are monitored and discussed at the Committee. • Following review by the GEC, the Quarterly Group Risk Management Report is submitted to the Audit Committee with a summary of the material risks circulated to the Board. "Deep dive" presentations on selected risks are given to the Audit Committee for more detailed review.
Our Risk Review Process for Investment Decisions	• All new investments must be endorsed by Management's Investment Committee, chaired by the CEO, before seeking approval from the Board or Finance & General Committee. • We require independent functional review and sign-off of any investment proposal before submission to the Investment Committee. Group Risk Management sign-off is part of the investment review process. • Group Risk Management requires that the project owner conducts a risk assessment with proper documentation. Detailed checklists and worksheets are adopted for identifying risks/mitigations and assessing risk level. Material risks and associated mitigations are highlighted and discussed at the Investment Committee.
Our Risk Management in the Business Planning Process	• In our annual business planning process, business units are required to identify all material risks that may impact their achievement of business objectives. Identified risks are evaluated based on the same set of risk criteria as the quarterly risk review process. Plans to mitigate the identified risks are developed for implementation and budget allocation purposes. The material risks set out later have been extracted from our 2012 business planning process.

(CLP Holdings Limited, Annual Report 2012)

Theme A: Examples – sub-theme (A.3): A company's internal controls system (control environment, control activities, information and communications, monitoring aspects)

Example 2

The following example illustrates a company's control procedures established pursuant to COSO standards, spanning control environment (e.g., tone at the top; a whistle blowing policy to safeguard integrity); control activities (e.g., established structure with clear segregation of duties; financial controls and IT controls); information and communications (e.g., timely communication within the organisation, as well as with its stakeholders; dissemination of inside information); and monitoring (e.g., on-going monitoring activities; internal audit):

Key control procedures

An internal control and risk management system, which is an integral part of the Group's management system, is on a par with the COSO (Committee of Sponsoring Organizations of the Treadway Commission) standards, and is designed to provide reasonable, though not absolute, assurance against material misstatement or loss and to manage rather than eliminate risks of failure to achieve business objectives. Key control procedures and measures include:

- Establishing a structure with defined authority and proper segregation of duties
  - A clear organisational structure with defined lines of responsibility to facilitate systematic delegation of authority
  - Written policies, procedures and guidelines with defined limits of delegated authority to facilitate effective segregation of duties and controls
- Monitoring the strategic plan and performance
  - A 3-year strategic plan prepared with inputs from Division/Department Heads lays down the corporate strategies, and provides guidance for the preparation of the annual operating plan
  - The relevant Divisions/Departments carry out their respective business operating plans as laid down in the strategic plan in accordance with the adopted policies and procedures
  - An annual budget with financial targets provides the foundation for the allocation of resources in accordance with prioritised business opportunities
  - Variance analyses help identify deficiencies and enables timely remedial actions to be taken
- Designing an effective accounting and information system
  - A comprehensive accounting system for providing financial and operational performance indicators to facilitate problem identification, and to ensure complete and accurate financial information for timely reporting and disclosure purpose
  - An information system for identifying, capturing and communicating pertinent information to enable employees to carry out their responsibilities
  - Regular reviews for ensuring proper and legitimate dissemination of financial information
  - System and procedures are in place to identify, assess and manage risks including legal, credit, market, concentration, operational, environmental, behavioural and systematic risks that may have an impact on the Cash and Derivatives Markets in Hong Kong. Exposure to these risks is monitored by the Management Committee, the Executive Committee, and the Risk Management Committee on a continual basis

(Hong Kong Exchanges and Clearing Limited's website, referred to in its Annual Report 2012)

Sub-theme (A.4): Improvement areas and the way forward

As discussed in the Implementation Guide, the system of control should (i) be **embedded in the operations** of the issuer and form part of its culture; (ii) be capable of **responding quickly to evolving risks** to the business arising from internal changes, as well as changes in the business environment; (iii) include procedures for **immediate reporting of significant control failings and corrective actions** taken.

Therefore, internal control and risk management should be part of **a continuing process**. A company may start off by building the relevant risk governance structure, system, processes and tools. However, the system will be most effective if it is embedded in the company's culture and business operations, in other words, a "living" system implemented by the operating units and other relevant parts of the organisation.

Theme A: Examples – sub-theme (A.4): improvement areas and the way forward

Example 3

The following company sets out its improvement actions taken during the year as well as the way forward. These include further embedding the integration of risk management into its strategy development and other business planning processes. The completion of the improvement steps is reported in the following year's report. (See example for sub-theme (3) above):

Major Initiatives in 2011	Examples of some initiatives
Process	• Enhanced our risk management framework by reinforcing risk ownerships, defining Group level risk criteria, and standardising risk languages amongst business units. • Established and implemented a quarterly reporting process of top tier risks by business and functional units, with review by the Group Executive Committee, oversight by the Audit Committee, and summary submission to the Board; deep dive presentations on selected risks are produced as required.

Outlook and Major Initiatives for 2012

- Continue to enhance our risk management framework and assist business units in roll-out and implementation of their own frameworks.
- CLP Power will roll-out an improved risk management framework with cross-functional risk management committee or similar entity established.
- Majority-owned Chinese assets to develop operational risk management frameworks.
- Embed the integration of risk management into strategy development and business planning processes.
- Facilitate efficient identification of emerging risks.
- Extend investment risk review as appropriate for projects entering commercial operations phase.

(CLP Holdings Limited, Annual Report 2011)

Theme C: The board has to review the system's effectiveness and report to the shareholders at least on an annual basis.

It should obtain the necessary assurance from other stakeholders, including management's on-going monitoring, the work of (where applicable) internal audit and other assurance providers (e.g., external auditors).

This theme flows from Theme B (the board's responsibility for the issuer's maintaining an effective internal controls system). **The board should**, therefore, **define the process to be adopted for its review** of internal control efficiencies, including the **source of "assurance" received during the year** and the **annual assessment process** itself. The source of assurance includes the scope and frequency of reports from the management, internal auditor and external auditor, if applicable. As explained earlier, the role of **board committees** in the review process, including that of the audit committee, is for the board to decide.

Report users would appreciate an **understanding of the process the board has actually gone through** for the purpose of giving the **"internal controls effectiveness" statement**.

Theme C: Example

The following international example gives a very comprehensive list of the source and frequency of various forms of assurance that the board received, including from the management, internal auditor, and external auditor:

Internal controls
During the year we have examined the key elements of the internal control processes and provided assurance to the Board on the effectiveness of the internal control environment. Set out below are a number of the activities that have been completed in our review of financial, operational and compliance controls.

- We considered the results of internal control self-assessment returns from the businesses and reviewed management responses to any identified weaknesses.
- We received a report from the external auditor which set out their key observations on the internal control environment that had arisen during their annual audit, along with management's remediation plans to strengthen further the internal controls within the Group.
- At most meetings we receive a summary of the financial control audits performed by Internal Audit, including the key recommendations. The audits include reviews of processes relating to accounting and finance, revenue, project management and contracting, capital expenditure, procurement, inventory, payroll and general computer controls. Last year we reported that particular attention had been given to ensuring a timely remediation of any audit recommendations; this rigour has continued this year with updates provided at each meeting.
- We reviewed arrangements under which employees can, on a confidential basis, raise concerns about potential irregularities in financial reporting or other matters, and the arrangements for follow-up actions.
- Significant variances between results and internal forecasts are considered and where such variances are indicative of control failings, management actions to address weaknesses are reviewed.
- We continue to focus on system tools to tighten our internal controls, for example establishing an automated ledger link between general ledgers and sub-ledgers in our ERP systems in the businesses to the Group's financial consolidation system that ensures a full audit trail and no allowance for manual entries.
- The Audit Committee receives a regular and comprehensive review of internal controls and accounting matters in advance of each results announcement.

The Board's review of the risk management process and its statement on internal control is contained on page •.

Risk management
As the Audit Committee is responsible for reviewing risk management processes and reporting systems on behalf of the Board, presentation of an update from the Chairman of the Risk Committee has become a regular cadence. A standardised approach to the completion of project risk registers has facilitated reporting to the Audit Committee and enabled more sophisticated and meaningful reports.

As well as reviewing the major risks in more detail, we monitored the mitigation actions put in place by management.

(Invensys plc, Annual Report 2013)

Theme D: A high-level disclosure of key risks facing the issuer, their impact and the mitigating measures taken.

The previous theme deals with disclosing the **process**. In terms of **substantive issues**, what are the key risks facing the company, their impact and mitigating measures that have been taken? It is also important to **link** the description with the **specific strategy** and risks **during the year**. What, for instance, are the changes during the year?

Theme D: Examples

Example 1

In this example of a public utility group, regulatory and political risk is one of the key risks it faced during the year. In the following extract, developments in this risk category during the year, risk assessment, and key risk mitigating measures are set out clearly:

Regulatory Risk across the Group
Globally, we have seen both a rise in governments' desire to intervene more directly in the privately-owned power sector, with strengthened regulatory control, and public support for such measures. The global financial crisis has brought increased public focus on the affordability of government and/or regulated services, including electricity. Pressure on electricity tariffs is affecting the financial standing and outlook of the power sector. All CLP's businesses operate under various local and national regulatory regimes and are currently facing the risk of adverse regulatory changes.

Risk Identification	Risk Assessment	Key Risk Mitigations
Regulatory and political risk of Hong Kong (HK) business	Rising costs and tariff increases have become a regulatory challenge for the HK business. We are not only encountering short-term risk with Government's difficulty in explaining the cost implications of its own policy decisions, but also long-term risk of adverse regulatory changes to the SoC. Whilst we have improved communication, explaining the link between higher tariffs and the rising cost of gas purchases, many stakeholders continue to express concern about higher tariffs.	• Implement Stakeholder Engagement Plan. • Strengthen cost justification and transparency. • Explore further stringent control over operating costs. • Enhance capital project development and prioritisation process. • Publicity and brand building to reinforce appreciation of CLP's performance and the value of its service to customers. • Help customers mitigate tariff impact. • Prepare for the discussion on future market developments with Government and the public.

(CLP Holding Limited, Annual Report 2012)

Example 2

In this example of a hotel operator, the descriptions of some key risks it faced during the year have been extracted. These include expenditure (in the light of its on-going refurbishment plans) and other risks specific to the service industry (e.g., health and safety for visitors, data privacy and damage to reputation by social media).

Inability to fund capital expenditure to maintain and renovate existing properties could reduce our profits

Risk Description	Risk Mitigation
Capital expenditure to develop, maintain and renovate our existing properties is critical to our business. If we are forced to spend larger amounts of cash from operating activities than anticipated to operate, maintain or renovate existing properties, our ability to invest in new business opportunities could be limited. In addition, we may need to postpone or cancel other planned renovations or developments to meet such cash demands, which could impact our ability to compete effectively.	• On-going regular maintenance of hardware standards • Continuous monitoring of furniture, fixture & equipment spend by operations and Head Office

Failure to address health and safety issues could result in guest or employee injuries or illness

Risk Description	Risk Mitigation
Our operations, merchandise and the properties we own and manage are subject to extensive health and safety laws and regulations of various local and national governments. Failure to timely address health and safety issues or comply with these laws and regulations could expose us to costs and liabilities.	• Professionally certified premises and staff • Policies and procedures on handling food, waste, and any hazardous materials • Robust crisis management process, ongoing risk assessment exercises, regular health consultations, etc.

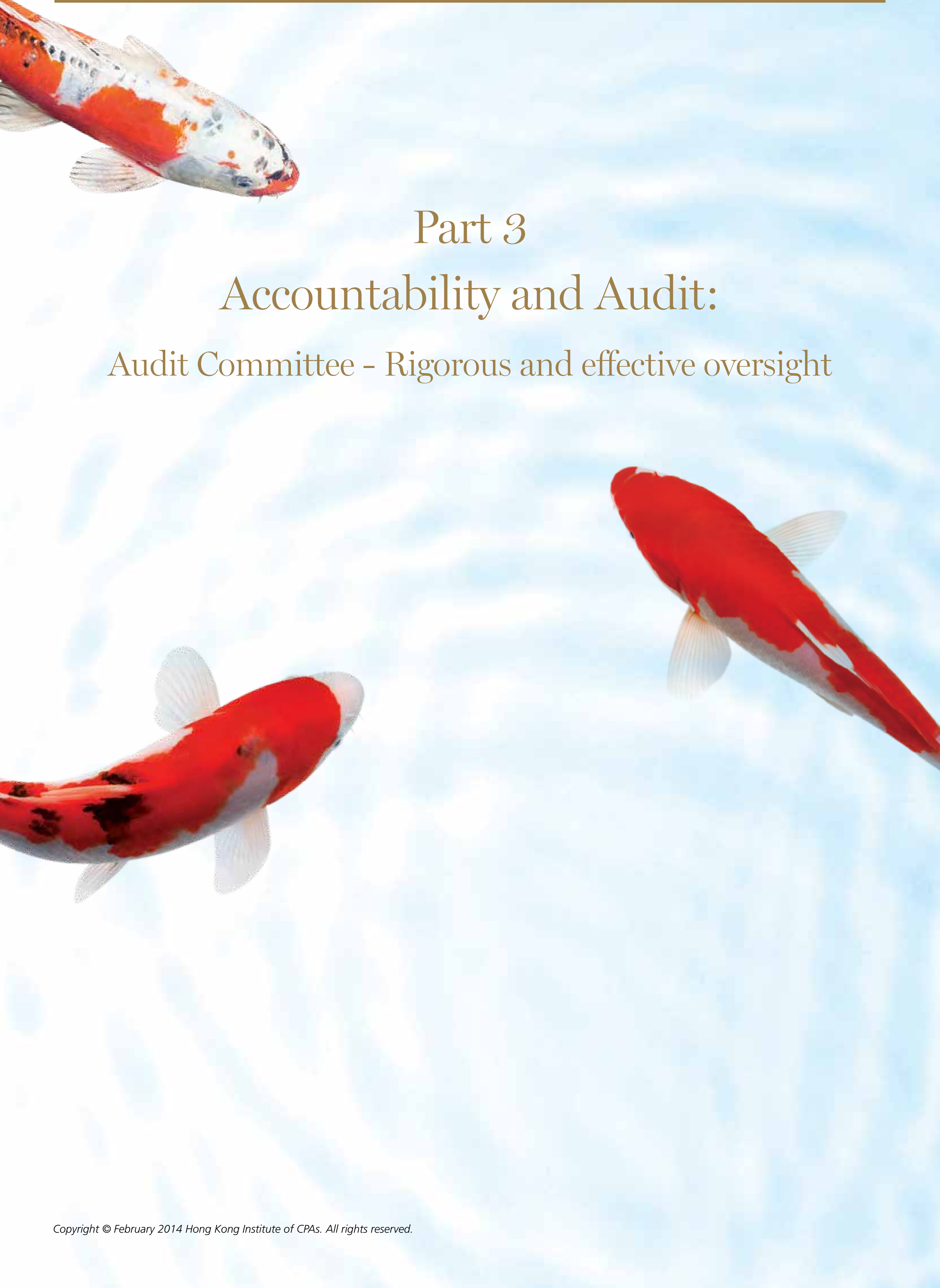
Breach of data privacy could subject us to fines and costs

Risk Description	Risk Mitigation
Collection and usage of information relating to our guests, customers and employees for various business purposes, including marketing and promotional purposes, are governed by privacy laws and regulations in jurisdictions around the world. New privacy regulations could increase our operating costs, and impact our ability to market our products, properties and services to our guests. Failure to comply with applicable privacy regulations could also result in fines, and harm the value of our brand and impact our business.	• Implementation of Group-wide data privacy policy and manual and training • Assessment by data privacy teams across operations • Process for reporting and dealing with data breaches

Damage to reputation may be caused by negative comments on social media

Risk Description	Risk Mitigation
Negative comments made on social media, in the absence of a verification mechanism, including those by disgruntled staff and guests could damage our reputation. In addition, monitoring and management of social media could be costly and force us to divert our resources. Failure to maintain and protect our reputation from social media damage could tarnish our brand and impair our business.	• Implementation of Group-wide social media usage guidelines • Social media monitored by external service provider

(The Hongkong and Shanghai Hotels, Limited Annual Report 2012)



Part 3

Accountability and Audit:

Audit Committee - Rigorous and effective oversight

Summary of relevant sections of the Corporate Governance Code ("Code") (Appendix 14 Main Board and Appendix 15 Growth Enterprise Market Listing Rules)

<u>Code Section C.3 – Audit Committee: Principle</u>

The **board** should establish formal and transparent **arrangements** to consider **how** it will **apply financial reporting and internal control principles** and **maintain** an **appropriate relationship** with the issuer's **auditors**. The **audit committee ("AC")** established under the Listing Rules should have **clear terms of reference**.

- **Code Provisions**:

There are Code Provisions laying down detailed requirements on various aspects of the AC. In addition to requirements on **membership** (C.3.2) and **processes** (e.g. meeting minutes and secretary) (C.3.1), there are detailed Code Provisions setting out minimum requirements for the AC's **terms of reference (C.3.3)**. These include an issuer's **relationship with its auditors**, review of the issuer's **financial information**, oversight of the issuer's **financial reporting system** and **internal control procedures**, as well as their respective focus areas of review.

- **Corporate Governance Report** ("CG Report"):

An issuer's **CG report** must include a **summary of the work of the AC during the year**...a report on **how** it meets **its responsibilities** in its **review** of...**half yearly** and **annual results** and **internal controls** systems...**other duties** under the Code (L.(d)(iv)).

1. Analysis: Themes underlying the Code requirements

1.1 To us, the key is the **effectiveness** of an issuer's AC in discharging its responsibilities under the terms of reference. There are the following underlying themes:

A. AC members, in particular its chairman, must possess the right skills and experience to effectively carry out their responsibilities.

B. A good process facilitates the working of the AC.

C. The AC should carry out its responsibilities in an objective and conscientious manner, to effectively monitor the integrity of the company's financial reporting and maintain oversight of its internal control and risk management systems and other relevant internal processes, as stated in its terms of reference.

D. In fulfilling its responsibilities, the AC should engage with and assess the effectiveness of the work of external and internal auditors.

1.2 In addition, investors would also be interested to know:

E. How the AC's focus, including new areas of focus, during the year link to the issuer's strategy, development, and changing risks.

1.3 **Evaluation of the effectiveness and performance of the AC**. As with the board as a whole, it would be useful for the AC to evaluate its own performance. Results of any evaluation and follow-up actions should be disclosed in the appropriate report to shareholders.

2. How to provide meaningful disclosure in relation to the key themes

As discussed in the earlier section, the key to implementing the Code in this area is the effectiveness of the AC in discharging its responsibilities. In terms of disclosure, it would therefore be useful to **describe the approach taken by the AC** and, **in general terms, the factors considered and discussed** by it in dealing with each major area of its responsibilities. This should give report users, including investors, a **meaningful and convincing account** of the **rigorous approach** taken by the AC in discharging its duties.

Under each theme, we have included brief **commentary**. **Examples** are also provided to illustrate and highlight the relevant issues, where appropriate.

Theme A: AC members, in particular its chairman, must possess the right skills and experience to effectively carry out their responsibilities.

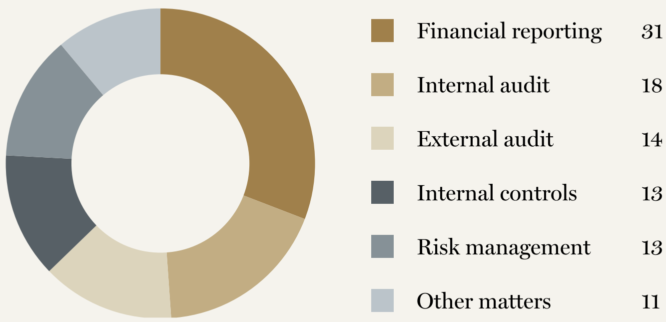
AC members typically need to have a good understanding of the business of the company and the industry in which it operates, and to have, at least, an overview of the internal and external risks faced by the company. In order to carry out their oversight role effectively, AC members also generally need to have a good understanding of areas such as financial reporting, internal controls and risk management, as well as regulatory compliance. The chairman, in particular, plays an important role. It would be useful to describe these matters in general terms.

Theme B: A good process facilitates the working of the AC.

Theme B: Example

In the following international example, the company publishes an audit committee report signed off by its chairman. There is a chart setting out how the committee spent its time and the committee chairman also describes how he implemented processes to further enhance the effectiveness of the committee.

How the Audit Committee spent its time (%)



Meetings
The Audit Committee held five scheduled meetings during the year and details of members' attendance are set out on page •.

The chart above shows how we spent our time and our activities are described in detail on pages • to •.

In addition, I meet periodically with the Chief Financial Officer for business updates with particular emphasis on financial performance. In advance of each Audit Committee, I meet with key executives and the external auditor to ensure that the reporting and discussion will appropriately address the Audit Committee agenda matters. At the time of the half-year and full-year results, I have a private meeting with the external auditor to ensure that any issues they have identified are raised and discussed appropriately at the subsequent Audit Committee meeting. Furthermore, the Audit Committee has a private meeting with the external auditor at least once a year, without management being present, to discuss their remit and any issues arising from the audit.

(Invensys plc, Annual Report 2013)

Theme C: The AC should carry out its responsibilities in an objective and conscientious manner, to effectively monitor the integrity of the company's financial reporting and maintain oversight of its internal control and risk management systems and other relevant internal processes, as stated in its terms of reference.

Under its terms of reference (including those terms required under the Code Provisions), the AC has responsibilities in the areas indicated below. In each case, it would be helpful to describe the factors considered and discussed by the AC, to illustrate the rigorous approach adopted by the committee.

Sub-theme (C.1): Financial reporting

The AC is responsible for monitoring the integrity of the issuer's financial statements and annual reports and accounts, half-year reports and, if prepared for publication, quarterly reports. Amongst other things, significant financial reporting judgments should be reviewed (C.3.3(d)). After completing its review, the AC makes a recommendation to the board in respect of the approval of those financial statements and reports.

The AC's role in the process would be to act as a counterpoint to management by asking questions to ensure the appropriateness and quality of the information being provided for review and the material judgments taken.

The AC has a responsibility to consider the information in sufficient detail to be able to identify areas that require further clarification. The review would be guided by the AC's understanding of the processes that result in the information being produced. However, areas that may require special focus, some of which are also covered in the Code Provisions (C.3.3(d)(i)-(vi)), could include:

- How the company's accounting policies compare with those of similar companies in the same industry.
- Changes to accounting policies during the period.
- Areas requiring a high level of judgment or estimation.
- Major transactions conducted during the period and how they have been accounted for.
- Narrative disclosures describing sensitive matters, such as the going concern assumption, related party transactions, contingent liabilities or breaches of regulations, law and the related impact on the financial information, etc.

Theme C: Example – sub-theme (C.1): financial reporting

In the following example, the AC report specifically highlights areas of focus when reviewing the financial information and how the AC members involved themselves so as to ensure that they felt comfortable with these:

Financial Statements – Judgmental Issues
The Audit Committee paid particular regard to judgmental issues in respect of the Company's Financial Statements for the years ended 31 December 2011 and 2012 and for the six months ended 30 June 2012. Amongst other inputs, the management reports to the Committee and the audit reports submitted by external auditor summarised matters of the CLP Group for the years ended 31 December 2011 and 2012 and for the six months ended 30 June 2012, such as in respect of auditing and accounting matters, taxation issues and internal controls, together with the manner in which they had been addressed.

During the Relevant Period the major judgmental issues included, by way of example, the accounting treatment of the flooding at Yallourn and changes in the tax consolidation rules in Australia, as well as the deferred taxation in India and the impairment review of Jhajjar Power Station. In August 2012 members of the Committee visited Australia and reviewed at first-hand the situation at Yallourn. For the purposes of their review of the Financial Statements ended 31 December 2012 the Audit Committee visited India at the end of January 2013 and met local management and local external auditors to consider judgmental issues regarding the accounting treatment of the Company's investments and activities in India.

(CLP Holdings Limited, Annual Report 2012)

Sub-theme (C.2): Review of internal controls and risk management

Under the Code Provisions (C.3.3(e)), the AC's terms of reference make it clear that the committee has a continuing responsibility for reviewing the issuer's financial control, internal controls and risk management systems. Again, it is important for report users to appreciate the **processes carried out by the AC** in performing its **reviews**, including the types and sources of appropriate **assurance provided** by management, external and internal auditors, where applicable.

(See the separate section on "**Accountability and Audit – Internal Controls**")

Theme D: In fulfilling its responsibilities, the AC should engage with and assess the effectiveness of the work of external and internal auditors.

In discharging its responsibilities, the AC will interact with, and assess the effectiveness of the work done by the internal auditors and external auditors. It would be useful to list the issues considered and discussed by the AC in each case, so that report users can feel reasonably assured that the AC has fulfilled its role diligently.

Sub-theme (D.1): Interaction with internal auditors

Typically, the AC has oversight of the internal audit function (or other similar function), with the head of internal audit reporting directly to the AC. The AC will seek to satisfy itself that the internal auditors have carried out an appropriate scope of work, focused on the areas considered by the AC to be the most important or high risk areas within the organisation and that their findings are being appropriately addressed by the management. The AC may also be interested in the level of coordination between the internal and external auditors.

Theme D: Example – sub-theme (D.1): interaction with internal auditors

The following is an international example of how the AC interacts with the internal auditors:

Internal audit
A substantial agenda item at each Committee meeting is the monitoring and reviewing of the scope, extent and effectiveness of the activity of the Group Internal Audit department. Reports from the Group Audit Director usually include updates on audit activities, progress of the Group audit plan, the results of any unsatisfactory audits and the action plans to address these areas, and resource requirements of the internal audit department. Further we receive summaries of investigations into known or suspected fraudulent activities by both third parties and employees. We hold private discussions with the Group Audit Director as necessary throughout the year and I also meet with the Group Audit Director outside the formal committee process.

(Vodafone Group plc, Annual Report 2012)

Sub-theme (D.2): Interaction with external auditors and review of their effectiveness

Under the Code Provisions, the AC has specific responsibilities with regard to an issuer's external auditors, including making recommendations on their appointment, re-appointment and removal (C.3.3(a)-(c)). One of the areas that report users may therefore be interested in is how the AC evaluates the effectiveness of the external auditors, and the factors considered.

Theme D: Examples – sub-theme (D.2): external auditors

Example 1

In the following international example, the AC chairman explains the details of the discussions with the external auditors:

External audit

The effectiveness of the external audit process is dependent on appropriate audit risk identification and at the start of the audit cycle we receive from Deloitte LLP a detailed audit plan, identifying their assessment of these key risks. For 2012 the primary risks identified were in relation to goodwill impairment, provisioning for current tax liabilities and deferred tax asset recognition due to the inherent management judgement required in these areas. These risks are tracked through the year whenever we receive reporting from Deloitte LLP.

We hold private meetings with the external auditor at each Committee meeting to provide additional opportunity for open dialogue and feedback from the Committee and the auditor without management being present. Matters typically discussed include the auditor's assessment of business risks and management activity thereon, the transparency and openness of interactions with management, confirmation that there has been no restriction in scope placed on them by management, independence of their audit and how they have exercised professional scepticism. I also meet with the external audit partner outside the formal committee process throughout the year.

(Vodafone Group plc, Annual Report 2012)

Example 2

In the following international example, further details are provided as to the process that the AC follows in order to conclude on the effectiveness of the external auditors:

PricewaterhouseCoopers LLP ('PwC') has served as the Company's auditors since 1983. The partner engaged on the audit is changed regularly. The services provided by PwC have been reviewed periodically and the Audit Committee is satisfied that they remain appropriately independent and are best placed to conduct the Company's audit for 2013/14. The Committee therefore recommended PwC be reappointed as the Company's auditors.

It is essential for the Committee to be able to have an honest and open relationship with both its external and internal auditors. This relationship is developed and maintained through regular private meetings with both PwC and the Head of Internal Audit. Further information on the role of the external auditors and our Non-audit Service Policy can be found on page •.

The Committee assessed the effectiveness of the external audit process by means of a detailed questionnaire completed by key stakeholders including the Board, the Executive Committee, members of senior management and Internal Audit. The questionnaire assesses the external audit in the following areas: qualification; expertise and resources; operational effectiveness; independence and leadership. The results are rated against an ideal standard and compared to prior years to assess the consistency of performance.

(Tesco plc, Annual Report 2013)

Theme E: How the AC's focus, including new areas of focus, during the year link to the issuer's strategy, development, and changing risks.

As in the case of the board as a whole, report users would be interested in understanding more about the year-on-year focus areas of the AC. For instance, they may want to know how the AC's work during the year links with the company's strategy, development and changing risks.

Theme E: Examples

Example 1

In the following international example, the company describes the changing external (macro environment) and internal (expansion overseas) changes, which underline the sharpened focus of its AC:

> The continuing effects of an uncertain global political and economic environment make it even more important to maintain a sharp focus on the robustness of the company's internal control and compliance models…
>
> During 2012, the Committee's agenda has included the usual review of our financial results and controls, our business operations across the world and their management of risk, as well as focusing consideration on new emerging risks. At each meeting, a proactive approach was taken to the identification and discussion of emerging risks…
>
> In line with the Group's strategy to expand further and deeper into emerging markets, members of the Committee visited the Group's [Indian] operations in [Delhi] and were pleased to have the opportunity to meet with locally based executives. During this visit, gain a deeper understanding of the distinctive business and cultural dynamics of this emerging market and to learn at firsthand how risk management is embedded in our operations in India.

(GSK, Annual Report 2012)

Example 2

In the following international example, the company obtained its stock exchange listing a few years ago. It describes the different circumstances, and so the changing focus of its AC, since its initial public offering:

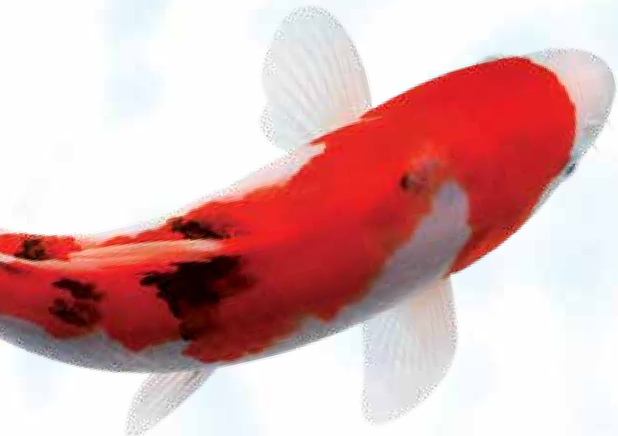
> The role of your Audit Committee has developed substantially over the last five years since our listing on the Stock Exchange. Initially, we focused on financial accounting and reporting together with internal controls, concentrating on the judgemental areas in the financial statements. This remains our first priority but we have increasingly focused on the oversight of management's processes to implement the risk management framework. We have refined our methodologies to assess transactions with any related party, including access to independent advisers, to address the requirement to ensure that any such transaction is on terms that are reasonable for all our shareholders. We have facilitated a deeper understanding of the processes of internal and external audit and fostered greater coordination between them to ensure that all the audit resources available to us are focused on the risks inherent in our strategy set out on pages • of the Annual Report…
>
> The above, however, is history; our priorities over the next few years, in addition to our normal review of financial statements and related accounting policies, are:
>
> - Continuing to monitor the implementation of the risk management controls to ensure that they are embedded within the organisation.
> - Ensuring that the internal control environment responds effectively to the organisational growth of the Group as implementation of our strategy unfolds and that internal audit is appropriately aligned in accordance with the suggestions included in independent report that we commissioned this year.
> - Monitoring the embedding of robust third party contractor processes.
> - Ensuring that the procedures for managing transactions with the controlling shareholder and related parties keep pace with emerging regulation and best practice.

(Fresnillo plc, Annual Report 2012)

Part 4

Communication with Shareholders:

Encouraging participation by shareholders



Summary of relevant sections of the Corporate Governance Code ("Code") (Appendix 14 Main Board and Appendix 15 Growth Enterprise Market Listing Rules)

Code Section E.1 - Communication with Shareholders: Principle
The board should be responsible for maintaining **on-going dialogue** with **shareholders** and in particular, use **annual general meetings ("AGMs")** or other general meetings to **communicate** with them and **encourage** their **participation**.

- **Code Provisions**:

There are detailed Code Provisions governing (i) AGMs (e.g. attendance by board members; notice period; voting procedures) and (ii) establishment of a shareholders' communication policy by the board. (E.1.1-E.1.4).

- **Corporate Governance Report** ("CG Report"):

There is no separate requirement for the CG Report.

1. Analysis: Key themes underlying the Code requirements

1.1 Underlying all these is the principle to encourage **effective participation by shareholders**. Arising from this is the need to ensure an **effective dialogue with shareholders** – hence the board chairman, committee chairmen and external auditors are expected to attend the AGM and be available to answer questions.

1.2 While **AGMs** are a **special focus** of the shareholders' communication policy under the Code, it is important that there be an on-going dialogue with shareholders generally.

1.3 To sum up, there are the following key themes:

A. The board should maintain an effective on-going dialogue with shareholders.

B. AGMs are a special focus of the shareholders' communication policy and should be treated as an opportunity to enhance two-way communication with shareholders.

2. How to provide meaningful disclosure in relation to the key themes

As indicated above, the key is how the board maintains an effective dialogue and communication with shareholders. In terms of disclosure, it is helpful to describe the key aspects of the communications policy. Regarding AGMs, what special efforts have been made to encourage shareholder participation?

Under each theme, we have included brief **commentary**, with **examples**, where appropriate. Additional information that an issuer's report users, including investors, may consider useful, is also explained.

Theme A: The board should maintain effective on-going dialogue with shareholders.

Sub-theme (A.1): Shareholder communication policy

An issuer may have different shareholder communication programmes, depending on its shareholder base, including its geographical spread. A shareholder communication policy serves to clearly explain the guiding principles and how they should be executed in practice.

For institutional shareholders, the policy may include senior management participation in "roadshow" meetings and meetings at industry conferences, shareholder tours to company properties and facilities, and communication with analysts and institutional investors (including one-on-one meetings).

Electronic communications are becoming increasingly important. Company websites may be the first point of contact. It is helpful to have a dedicated, regularly-updated investor relations section. Presentations delivered by management (including to analysts) and interviews with management could be made available, including, where available, webcast facilities, in the investor relations section. Other channels of communication may include mobile sites, online (interactive) annual reports (including supplementary reports, such as corporate social responsibility or sustainability reports) and smart phone applications.

In addition to accessing information on the company's website, investors and other report users should be able to contact the company at any time by email, telephone or in writing. The company should provide points of contact and should undertake to answer any enquiry within a certain time frame. Internally, the company should have a register to record all enquiries and whether they have been responded to properly.

The contact details of designated company officers should be clearly identified on the company's website, in the annual report and in other communications.

While the company should engage in an ongoing dialogue with shareholders, it is important to avoid selective disclosure. It is particularly important where this may involve "inside information", under the new Part XIVA of the Securities and Futures Ordinance (Cap.571), as selective disclosure of inside information may constitute a breach of the law.

Theme A: Examples

In the following example, the company sets out its objective to enable shareholders to engage actively with it and the company provides information on its shareholders' communication policy (the full statement of which is available on its website), communication with investors during the year, and contacts. It has a designated "investor's information" section on its website containing additional information.

Enquiries from Shareholders

The Company has a Shareholders' Communication Policy to provide shareholders with information about the Company to enable them to engage actively with the Company and exercise their rights as shareholders in an informed manner.

The Company's Shareholders Communication Policy available on both the websites of the Company and the Stock Exchange, has set out, amongst other things, a channel for shareholders' access to the Board and Management by writing to the Company Secretary of the Company.

Please also refer to the Investor Relations section on pages • to • on other means of communication with shareholders.

Communicating with Institutional Investors

Our proactive approach to investor relations has made the Company one of the most widely covered companies in Hong Kong. A significant number of local and international brokers publish reports on the Company, often on a regular basis. We are also followed by a wide range of institutional investors.

Management takes great efforts to maintain an open dialogue with the investment community to ensure a thorough understanding of the Company and its business strategies. To this end, we participate in investor conferences and roadshows. During 2012, nearly 300 meetings were held with institutional investors and research analysts in Hong Kong and internationally.

Access to Information

To ensure all shareholders have equal and timely access to important Company information, we make extensive use of the corporate website. The Investor Information section offers a level of information disclosure in readily accessible form. Financial reports, patronage figures, together with other Company news and stock exchange filings, are easily accessible on other sections of the website.

In addition to the shareholder services offered by Computershare, the Company's dedicated hotline answered more than 50,000 enquiries from individual shareholders in 2012.

(Both sections above taken from MTR Corporation Limited, Annual Report 2012)

Key Shareholder Information

Financial Calendar 2013

Announcement of 2012 annual results	11 March
Annual General Meeting	9 May
Last day to register for 2012 final dividend	14 May
Book closure period	15 to 21 May (both dates inclusive)
2012 final dividend payment date	On or about 5 June
Announcement of 2013 interim results	August
2013 interim dividend payment date	September
Financial year end	31 December

Principal Place of Business and Registered Office

MTR Corporation Limited, incorporated and domiciled in Hong Kong
MTR Headquarters Building, Telford Plaza, Kowloon Bay, Kowloon, Hong Kong
Telephone: (852) ••
Facsimile: (852) ••

Share Information

Listing

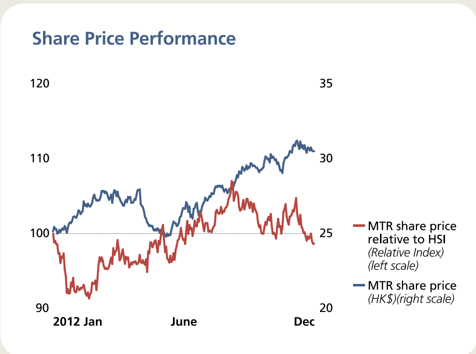
MTR Corporation Limited's shares are listed on the Stock Exchange of Hong Kong. In addition, shares are traded in the United States through an American Depositary Receipt ("ADR") Level 1 Programme sponsored by JPMorgan Chase Bank, N.A.

Ordinary Shares *(as at 31 December 2012)*

Shares outstanding	5,793,196,650 shares
Hong Kong SAR Government Shareholding	4,434,552,207 shares (76.5%)
Free float	1,358,644,443 shares (23.5%)

Nominal Value HK$1 per share

Market Capitalisation *(as at 31 December 2012)* HK$176,692 million



Dividend Policy

Subject to the financial performance of the Company, the Company intends to follow a progressive dividend policy. We also expect to pay two dividends each financial year with interim and final dividends payable around September and June respectively.

Dividend per Share	*(in HK$)*
2011 Total Dividend	0.76
2012 Interim Dividend	0.25
2012 Final Dividend	0.54

ADR Level 1 Programme

ADR to Ordinary Shares Ratio	1:10
Depositary Bank	JPMorgan Chase & Co. P.O. Box 64504 St. Paul, MN 55164-0504 U.S.A.

Stock Codes

Ordinary Shares

The Stock Exchange of Hong Kong	66
Reuters	0066.HK
Bloomberg	66 HK
ADR Level 1 Programme	MTRJY

Annual Report 2012

Shareholders can obtain copies of our annual report by writing to:
Computershare Hong Kong Investor Services Limited,
17M Floor, Hopewell Centre,
183 Queen's Road East, Wan Chai, Hong Kong

If you are not a shareholder, please write to:

Corporate Relations Department, MTR Corporation Limited
MTR Headquarters Building, Telford Plaza, Kowloon Bay,
Kowloon, Hong Kong

Our annual/interim reports and accounts are also available online at our corporate website at http://www.mtr.com.hk

Shareholder Services

Any matters relating to your shareholding, such as transfer of shares, change of name or address, and loss of share certificates should be addressed in writing to the Registrar:

Computershare Hong Kong Investor Services Limited
17M Floor, Hopewell Centre,
183 Queen's Road East, Wan Chai, Hong Kong
Telephone: (852) ••
Facsimile: (852) ••

Shareholder Enquiries

Shareholders are, at any time, welcome to raise questions and request information (to the extent it is publicly available) from the Board and management by writing to the Company Secretary, MTR Corporation Limited, MTR Headquarters Building, Telford Plaza, Kowloon Bay, Kowloon, Hong Kong. Any such letter should be marked "Shareholders' Communications" on the envelope.

Our enquiry hotline is operational during normal office hours:
Telephone: (852) ••

Investor Relations

For enquiries from institutional investors and securities analysts, please contact:

Investor Relations Department, MTR Corporation Limited
MTR Headquarters Building, Telford Plaza, Kowloon Bay,
Kowloon, Hong Kong

Email: investor@••

(MTR Corporation Limited, Annual Report 2012)

Sub-theme (A.2): Additional information

In addition, report users, including investors, would be interested to understand the following:

- *Co-ordinating disclosure of material information to shareholders and other report users*

  It is important for listed issuers to ensure consistent disclosure practices, aimed at accurate, timely and broadly-disseminated disclosure of material information about themselves. It is helpful to have in place a corporate disclosure policy providing guidance on co-ordinating the disclosure of material information to shareholders, the investment community, analysts and the media, as well as processes for results announcements. Typically, this policy would identify the persons that may speak on behalf of the company and outline the responsibilities for communication with various report user groups. It should encompass key principles, including the determination and handling of inside information, business updates, disclosure channels and avoidance of selective disclosure.

- *How is shareholder **feedback shared, discussed,** and **considered** by the board?*

  It is important to ensure that feedback from shareholders and the investment community is reported to the board on a regular basis. More importantly, investor feedback should not just be shared with the board and discussed, but should also be taken into consideration in board decisions and help the company to meet its objectives. Therefore, reports from the investor relations team should be a regular agenda item for each board meeting.

Theme B: AGMs are a special focus of the shareholders' communication policy and should be treated as an opportunity to enhance two-way communication with shareholders.

The AGM is an important forum for the board to meet shareholders, in particular, retail shareholders. Issuers should take steps to facilitate shareholders' participation, including by selecting an appropriate venue and timing, and providing a sufficient notice period.

The board chairman and chairmen of committees should be actively involved in the AGM and be available to participate in a dialogue with shareholders.

In addition to the statutory part of the meeting, issuers may consider incorporating a business review session.

It is useful to include a discussion session, allowing the chairman and other board members to answer shareholders' questions. Issuers may consider encouraging shareholders to submit their questions before the AGM, so that issuers have enough time to prepare answers and, at the same time, shareholders appreciate that their questions are welcomed.

Theme B: Example

The following international example reflects the company's efforts to encourage shareholder participation: The board and senior management made themselves available to speak to shareholders before the meeting and answered questions during the meeting. A live webcast was arranged and a recording of the meeting was posted on the company's website.

AGM
The AGM provides the Board with the opportunity to meet and engage directly with our shareholders, particularly our private shareholder. The 2012 AGM was held on *, the Board and the senior management were available to speak to before the meeting and the Chairman and Committee Chairmen answered shareholder questions during the formal part of the meeting, all resolutions were passed with votes ranging from * to *.

This year's AGM will be held at * on *. The Notice of Meeting sets out the schedule of the day and each of the resolutions being proposed at the meeting. A copy of the Notice can be downloaded at [link]. Once again the meeting will be webcast live and a recording of the meeting available on our website after the event.

Shareholders unable to attend the AGM are encouraged to vote in advance of the meeting, by using the proxy card sent with the Notice of Meeting.

(Marks and Spencer Group plc, Annual Report 2013)

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

37th Floor, Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong
Tel: (852) 2287-7228 Fax: (852) 2865-6603 Email: hkicpa@hkicpa@org.hk Web: www.hkicpa.org.hk