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Practical Approach to Internal Controls for Pre & Post IPOs in Hong Kong & China

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Presentation Outline

1. Corporate Governance and Internal Controls
2. Hong Kong Institute of CPAs “The Guide”
3. The Listing Rules- Appendix 14: *The Code*
4. The Committee of Sponsoring Organizations of the Treadway Commission ("COSO")
5. China: *Basic Rules for Corporate Internal Control* (“Rules”)
6. System of Internal Controls
7. Questions and answers



Terminology

1. Corporate Governance
2. Internal Controls
3. Hong Kong Institute of CPAs (“HKICPA”).
4. Internal Control and Risk Management Guide (“Guide”).
5. Code on Corporate Governance Practices contained in Appendix-14 of the Main Board Listing Rules (the “Code”).
6. China: *Basic Rules for Corporate Internal Control* (“Rules”)
7. The Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).



What is Corporate Governance

The system by which corporations are directed and controlled

The processes used to direct and manage the business and affairs of the company with the objective of balancing:

1. The attainment of corporate objectives
2. The alignment of corporate behaviour with the expectations of society
3. The accountability to recognized stakeholders



What is Internal Control

A process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives.



Internal Controls Address Three Main Areas

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations



Hong Kong Institute of CPAs: The *Guide*

1. In 2005, the HKICPA released the *Guide*, which provides a **basic conceptual framework**, general principles and recommendation for a system of internal control and risk management. It also outlines the responsibilities of the board of directors and senior management and the roles of the audit committee and internal auditors.
2. One of the *Guide* objectives states that establishing a sound system of internal control and reviewing its effectiveness **should be incorporated by the company within its normal management and corporate governance processes**.
3. The *Guide* states that the internal control effectiveness is part of the accountability of a company's board of directors and management to shareholders, and **should be treated as a separate exercise** undertaken to meet regulatory requirements issued and enforced by a securities market regulator.



HKICPA Statement on *the Guide*

The HKICPA states that “ *...the Guide will provide a useful reference for listed and group companies, as well as other companies that aim to implement or enhance their system of internal control.*”



COSO a U.S. Based Reference

COSO, the Committee of Sponsoring Organizations of the Treadway Commission, is a private sector initiative established in 1985 by five financial professional associations

1. The Institute of Internal Auditors
2. American Institute of Certified Public Accountants
3. American Accounting Association
4. Institute of Management Accountants
5. Financial Executives Institute



COSO's Five Components

COSO's goal is to improve the quality of financial reporting through a focus on corporate governance, ethical practices, and internal control.

1. Control Environment
2. Risk Assessment
3. Information and Communication
4. Control Activities
5. Monitoring



HKICPA Statement on COSO

The HKICPA has looked at conditions in Hong Kong and has drawn on important international benchmarks in the field of system of internal control and risk management, such as COSO.



The HKEx Listing Rules- Appendix 14: *The Code*

1. Listed companies are required to prepare a Corporate Governance Report, to be included in their annual report. Both *the Code* and the reporting requirements have improved awareness by companies and their directors of the importance of corporate governance.
2. The *Code*, with one exception, became effective for accounting periods commencing on or after 1 January 2005. The exception is in respect to *the Code provision C.2 on internal controls* and the proposed disclosure requirements in the Corporate Governance Report relating to listed issuers' internal controls, which take effect for accounting periods commencing on or after 1 July 2005.



The Listing Rule Requirements on Internal Control

- Principle of Section C.2 of *the Code* states that: *“The board should ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders’ investment and the issuer’s assets.”*
- Code provision of Section C.2.1 on “Internal Controls” states that: *“The directors should at least annually conduct a review of the effectiveness of the system of internal control of the issuer and its subsidiaries and report to 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.”*



Listing Rules- Appendix 14: *The Code* and COSO

1. Mapped *Section C.2 Internal Controls* of the Appendix-14 of the Listing Rules to the COSO controls.
2. It is evident that *the Code* is highly correlated to COSO internal controls for the Corporate Governance.



China: Basic Standard for Enterprise Internal Control- “Rule”

1. China Securities Regulatory Commission, the National Audit Office, China Banking Regulatory Commission and China Insurance Regulatory Commission have jointly announced on 28 June, 2008 the *Basic Standard for Enterprise Internal Control*, which requires listed Chinese companies to comply from 1 July, 2009 onward. Also, unlisted large and medium-sized Chinese companies are encouraged to adopt the standard.
2. The new rule requires listed companies to **conduct self-evaluation** of their internal controls, **disclose** an annual evaluation report and **employ qualified agencies** to audit the effectiveness of the controls.



The Rule: “The Basic Standard for Enterprise Internal Control”

1. The Basic Standard is intended to **bring stronger corporate governance to China's listed companies**, and is often compared to Sarbanes-Oxley.
2. The Basic Standard is currently in its public comment phase which lasts until September 30, 2008.
3. The Basic Standard will then undergo revisions, and become **effective on July 1, 2009**.



C-SOX is China Equivalent of the U.S. Sarbanes-Oxley: “*The Basic Standard for Enterprise Internal Control*”

1. The rule is regarded as the Chinese equivalent of the Sarbanes-Oxley Act of 2002 (SOX), ratified in the United States after the Enron scandal.
2. The U.S. law aims at protecting investors by improving the accuracy and reliability of corporate disclosures.



China Challenge to the Basic Standard for Enterprise Internal Control

The challenge is that the required commitment of the Chinese companies to implement internal control system is not to the level of heightened awareness of regulatory requirements.



Chinese Companies' Heightened Awareness and Knowledge of Internal Controls

Deloitte has identified the following key hurdles to
implementing strong internal controls:

1. Lack of support and guidance from senior management on internal control initiatives.
2. Lack of enterprise-wide control, governance structure becomes obsolete.
3. Shortage of qualified talent experienced in implementing internal control.
4. Lack of effective supervision and monitoring system, internal control becomes process-driven.
5. Too focused on short-term results while ignoring the need to establish long-term mechanism for internal control.
6. Inability to integrate internal control into daily operations.
7. Weak IT system control or the failure to integrate IT system with internal control requirements.

Reference: Deloitte Survey report issued
on July 2, 2008



Elements of a Sound System of Internal Control

1. It encompasses the processes, policies, procedures, tasks, behaviors and other aspects of a company.
2. It facilitates the company effective and efficient operation by enabling it to respond appropriately to:
 - ✓ Significant business, operational, financial, compliance and other risks in relation to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed.
 - ✓ It helps ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization.
 - ✓ It helps ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.



Guidelines to Improve Business Processes and Internal Controls

1. Internal controls are designed to provide reasonable, but not absolute, assurance regarding the safeguarding of resources, reliability of operating and financial information.
2. The cost of a control should not exceed the benefit to be derived from it.
3. All employees share responsibility for policy and IC compliance.
4. Senior management oversees the compliance and monitoring of the policies, procedures and internal controls.
5. Implementation of periodic and effective monitoring and reporting mechanisms for internal controls.



Steps of Internal Control Compliance

1. Develop and document *Corporate Governance and Entity Level Control*.
2. Develop and document *Accounting functions*: Policies, Procedures, Remediation, and Recommendations.
3. Develop and document *Operational functions*: Policies, Procedures, Remediation, and Recommendations.
4. Develop and document *Information Technology functions*: Policies, Procedures, Remediation, and Recommendations.
5. Develop and document *Semi Annual Monitoring and Testing* of Internal Control Activities.



Internal Controls: Review, Monitor, and Test

The company is required to file an internal control report with its annual report, stating the following:

1. Management's responsibilities to establish and maintain adequate internal controls and procedures for financial reporting.
2. Management support to any required certification by the company officers in support of the company requirements.
3. Management's conclusion on the effectiveness of these *internal controls* at year end.



Pre & Post IPO Deliverables- Internal Controls

1. Document and perform test of selected internal controls for the entity level, accounting, operations, and information technology processes.
2. Identify internal controls if any, which may require remediation and management attention.
3. Remediate controls with “Deficiency”.
4. Issue management report to the company Audit Committee and senior management team.



In support of Pre-and Post IPO

It is recommended that the Company undertakes several initiatives and approaches, which are in support of the regularity compliance of Corporate Governance and Internal Controls reporting:

1. Develop and update Corporate Governance, Accounting, Operations, and Information Technologies Policies & Procedures.
2. Perform Corporate Governance/Entity Level Control Assessment.
3. Perform Periodic Monitoring and Testing of the Company Internal Controls for the Accounting, Operations, and Information Technology core processes
4. Adopt the five (5) components of COSO framework: Control Environment, Risk Assessment, Information & Communication, Control Activities, and Monitoring



Desired conclusion of the Internal Controls Examination

Examination approach included procedures to obtain reasonable assurance about whether:

1. The internal controls are *in place*.
2. The stated controls were *operating effectively* as intended.
3. The controls had been placed in operation *during the period* of testing.