

Technical Bulletin

Assistance Options to New Applicants and Sponsors in connection with Due Diligence Obligations, including Internal Controls over Financial Reporting

This Technical Bulletin is issued by the Auditing and Assurance Standards Committee of the Hong Kong Institute of Certified Public Accountants (HKICPA). The Technical Bulletin does not constitute an auditing or assurance standard. Professional judgement should be used by members in its application. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Technical Bulletin can be accepted by the HKICPA.



Copyright 2013 The Hong Kong Institute of Certified Public Accountants. All rights reserved.

Permission is granted to make copies of this Technical Bulletin provided that such copies are for use in academic classrooms or for personal use and are not sold or disseminated, and provided further that each copy bears the following credit line: "Copyright by the Hong Kong Institute of Certified Public Accountants. All rights reserved. Used by permission". Otherwise, written permission from the HKICPA is required to reproduce, store or transmit this document, except as permitted by law.

This Technical Bulletin is prepared by the HKICPA and is intended to provide information to members on the current practices in Hong Kong in regard to such engagements only. Professional advice should be taken before applying the content of this publication to your particular circumstances. While the HKICPA endeavours to ensure that the information in this publication is correct, no responsibility for loss to any person acting or refraining from action as a result of using any such information can be accepted by the HKICPA.

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TECHNICAL BULLETIN – AATB 1 (REVISED)

ASSISTANCE OPTIONS TO NEW APPLICANTS AND SPONSORS IN CONNECTION WITH DUE DILIGENCE OBLIGATIONS, INCLUDING INTERNAL CONTROLS OVER FINANCIAL REPORTING

This Technical Bulletin is issued by the Auditing and Assurance Standards Committee of the Hong Kong Institute of Certified Public Accountants (HKICPA). The Technical Bulletin does not constitute an auditing or assurance standard. Professional judgement should be used by members in its application. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Technical Bulletin can be accepted by the HKICPA.

<u>Contents</u>	<u>Paragraph Numbers</u>
EXECUTIVE SUMMARY	1-12
A. Introduction	13-27
Part 1 – SUMMARY OF RESPECTIVE RESPONSIBILITIES OF DIRECTORS OF NEW APPLICANTS AND SPONSORS IN RESPECT OF DUE DILIGENCE OBLIGATIONS, INCLUDING INTERNAL CONTROLS OVER FINANCIAL REPORTING	
B. The responsibility of directors of new applicants	28
C. The Sponsors' declaration under Listing Rule 3A.13	29
Part 2 – THE SFC AND EXCHANGE'S EXPECTATIONS OF TYPICAL DUE DILIGENCE PERFORMED BY SPONSORS	
D. The SFC's expectations of Sponsors under the code of conduct	30-31
E. The Exchange's expectations of Sponsors under Practice Note 21	32-36
Part 3 – DISCUSSION OF TYPICAL TYPES OF ASSISTANCE TO BE PROVIDED BY ACCOUNTANTS	37-39
F. Long form report – internal controls over financial reporting	40-43
G. Agreed-upon procedures	44-46
H. Long form report – comprehensive review	47-51
Part 4 – ASSESSING AND REPORTING DEFICIENCIES	
I. Assessing and reporting deficiencies	52-59

Part 5 – OTHER MATTERS

- J. Meetings with Sponsors 60-61
- Appendix 1 – Matters to be considered over internal controls over financial reporting in respect of due diligence obligations
- Appendix 2 – Basic principles in achieving effective internal controls over financial reporting
- Appendix 3 – Illustrative scope of work in connection with due diligence assistance for internal controls over financial reporting
- Appendix 4 – Expressing assurance on internal controls over financial reporting

EXECUTIVE SUMMARY

1. This Technical Bulletin is intended as a guide for members in public practice providing assistance to new applicants and Sponsors in connection with due diligence by Sponsors in respect of initial listing applications.
2. It may or may not be the case that the accounting firm engaged to provide assistance to the new applicant and the Sponsors is the same firm that is acting as reporting accountants for the new applicant's planned listing. Nevertheless, in the interests of simplicity, for the purposes of this Technical Bulletin the accounting firm engaged to provide assistance to the new applicant and the Sponsors is referred to as "the accountants".
3. In recent years, such assistance has typically taken the form of a long form report or agreed-upon procedures engagement over a new applicant's internal controls over financial reporting¹ as described in sections F and G respectively of this Technical Bulletin. Another form of assistance could be an engagement to express assurance on internal controls over financial reporting, although this has not been a common market practice in Hong Kong in view of the relative immaturity of many new applicants' system of internal controls over financial reporting for reasons described in paragraph 14. Engagements to express assurance on internal controls over financial reporting are discussed in Appendix 4.
4. In December 2012, the Securities and Futures Commission ("SFC") published its consultation conclusions on the regulation of Sponsors in connection with Initial Public Offerings ("IPOs")². The reforms are aimed at ensuring Sponsors have a thorough understanding of the listing applicant prior to submitting a listing application and to enhance the quality of disclosures about the listing applicant. Many aspects of the new Sponsor regulations are known, for example, the process for public filing of the Application Proof, however, market practices will evolve over the months and years following the new regulations taking effect in October 2013. It can be expected, that the new focus on the role of the Sponsors in IPO transactions will lead to a greater focus on the role of accountants in providing due diligence assistance.
5. In addition to other requirements, such as the public filing of the Application Proof, Sponsors will be required to complete all reasonable due diligence on a listing applicant before submitting a listing application. In particular, Sponsors are required to come to a reasonable opinion that the listing applicant has established procedures, systems and controls (including accounting and management systems) which enable the listing applicant and its directors to comply with the Listing Rules and other relevant legal and regulatory requirements on an ongoing basis and that it has established procedures, systems and controls (including accounting and management systems) which provide a reasonable basis for the directors to make a proper assessment of the financial position and prospects of the listing applicant on an ongoing basis.

¹ The scope of internal controls over financial reporting is indicated by "Internal Control - Integrated Framework: Executive Summary, Framework and Appendices, and Illustrative Tools for Assessing Effectiveness of a System of Internal Control" issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. For the purposes of this Technical Bulletin internal controls over financial reporting are taken also to include certain relevant supplementary areas of financial control including over key business processes, forecasting and budgeting and management reporting. See Appendices 2 and 3.

² "Consultation Conclusions on the regulation of IPO sponsors" published by the Securities and Futures Commission in 2012.

6. Where material deficiencies are identified in relation to the operations and structure, procedures and systems, or directors and key senior managers of the listing applicant, the Sponsors will be required to provide adequate advice and recommendations to assist the listing applicant to remedy these material deficiencies, and to ensure that true, accurate and complete disclosure about the listing applicant is made to the public. Accountants can assist Sponsors in performing this function by the provision of services set out in this Technical Bulletin.
7. The SFC's consultation conclusions and subsequent amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct") have drawn attention to the quality and nature of due diligence expected to be performed by Sponsors. Practice Note 21 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited "Due Diligence by Sponsors in respect of Initial Listing Applications" ("Practice Note 21")³ sets out due diligence expectations beyond internal controls over financial reporting. Sponsors may wish to engage the accountants to perform a broader due diligence than has historically been requested.
8. These types of engagements (i.e. assurance on internal controls over financial reporting, long form or agreed-upon procedures) continue to be available when considering the broader scope of potential due diligence activities. These types of engagements should not, however, be viewed as alternatives that are available or appropriate in every instance.
9. A key difference between a long form report and an agreed-upon procedures engagement over a listing applicant's internal controls over financial reporting is that only the long form report would prioritise and categorise any deficiencies identified according to their relative level of significance or risk, or materiality, and contain recommendations for improvement to the extent that deficiencies are identified. An agreed-upon procedures assignment includes identification of certain deficiencies, but does not provide any views on materiality or recommendations as to how the deficiencies can be addressed. In the case of agreed-upon procedures the Sponsor would, therefore, need to make its own assessment of the materiality of the deficiencies identified and make appropriate recommendations for rectification in consultation with the listing applicant without the benefit of the recommendations in this regard of the accountants.
10. Another significant difference between a long form report and an agreed-upon procedures engagement over a listing applicant's internal controls over financial reporting is that only the long form report would contain a narrative and commentary on the internal controls and systems of the listing applicant and any additional due diligence related activities undertaken by the accountants. Sponsors may consider the additional commentary provided by the long form report helpful in achieving a thorough understanding of the listing applicant's systems, processes and controls.

³ The corresponding rules in the Rules Governing the Listing of Securities on the Growth Enterprise Market (GEM) of The Stock Exchange of Hong Kong Limited is Practice Note 2. For the purpose of this Technical Bulletin, the requirement under the Main Board Listing Rules is discussed. The same discussion is relevant to engagements in connection with listings on the GEM.

11. The accountants will need to work closely with the new applicant and the Sponsors to agree the most appropriate approach given the new applicant's circumstances and the requirements of the new applicant and the Sponsors. If the listing applicant has engaged the accountants to perform due diligence procedures prior to appointing a Sponsor, the scope of work should be discussed with the Sponsor upon appointment and amended as necessary. Before accepting any engagement, the accountants should ensure that they have adequate expertise commensurate with the scope of the due diligence engagement requested.
12. The new IPO Sponsor regulatory regime requires the Sponsor to ensure that the listing applicant is ready to be a listed entity at the time of submitting a listing application. It should be noted that the nature of the assistance provided by accountants to the Sponsor is time consuming. Although the timing will vary for each engagement, for a typical long form report covering internal controls over financial reporting, the accountants will require, in general, at least 4 weeks to carry out relevant procedures and prepare a preliminary report, with a further 4 weeks to consider the listing applicant's remediation activities and prepare the follow up report. It is, therefore, to the benefit of all parties that the work of the accountants be started as soon as the new applicant has the positive intention to seek a listing. This increases the time available for the listing applicant to consider the outcomes of the engagement and remediate any material deficiencies (see Section I below for definition of "material deficiencies") that come out of the accountants' work (either through recommendations in a long form report or from an assurance engagement, or by considering the report of factual findings in an agreed-upon procedures engagement).

A. Introduction

13. In preparing for listing the directors of a new applicant should ensure that the new applicant has the capability to meet the demands of a listed company, including having established procedures, systems and controls (including accounting and management systems) which enable the listing applicant and its directors to comply with the Listing Rules and other relevant legal and regulatory requirements on an ongoing basis and to provide a reasonable basis for the directors to make a proper assessment of the financial position and prospects of the listing applicant on an ongoing basis. This typically means that management performs some form of assessment of the sufficiency of the new applicant's readiness in the run up to listing.
14. In practice, although they may have a positive intention to seek a listing, new applicants may not yet have designed and implemented internal controls over financial reporting sufficient for a listed company. Reasons for this include:
 - (a) the group may only have been formed following a recent reorganisation in anticipation of listing, creating a new control environment; and
 - (b) whilst lower-level operational controls might be in place there is less in the way of the higher-level corporate and management controls required to enable management to plan the business and monitor its progress.
15. It has been indicated by the Sponsor community that it will normally be necessary for third party professionals to be engaged to assist them to undertake their due diligence enquiries. This assistance is likely, in a number of instances, to cover areas beyond the internal controls over financial reporting, as Sponsors seek to meet their broader obligations under Practice Note 21, and considering the Code of Conduct.

16. Under the Code of Conduct, Sponsors will be required to complete all reasonable due diligence on a listing applicant before submitting the listing application. Where material deficiencies are identified in relation to the operations and structure, procedures and systems, or directors and key senior managers of the listing applicant, a Sponsor should provide adequate advice and recommendations to assist the listing applicant to remedy these material deficiencies, and to ensure that true, accurate and complete disclosure about the listing applicant is made to the public.
17. Practice Note 21 sets out the expectation of the Stock Exchange regarding the due diligence activities to be performed by Sponsors. These expectations have been set out in Part 2 of this Technical Bulletin.
18. In practice, accounting firms in Hong Kong are commonly engaged by new applicants or jointly engaged by new applicants and Sponsors to perform work in connection with the due diligence expectations as set out in Practice Note 21.
19. Assurance engagements fall within the Hong Kong Framework for Assurance Engagements for which independence is required in accordance with the Code of Ethics for Professional Accountants issued by the HKICPA. Although long form report engagements as described herein and agreed-upon procedures engagements do not fall within the Hong Kong Framework for Assurance Engagements, the accountants should ensure that such non-assurance services do not impair their independence when the accountants are also the auditors and/or engaged as the reporting accountants for the IPO. In this context, consideration should be given to whether long form report engagements and agreed-upon procedures engagements should be performed in whole or in part by personnel not involved in the financial statement audit and accountants' report engagements and with different reporting lines within the firm. Irrespective of whether their work takes the form of a long form report, agreed-upon procedures or assurance engagement, the accountants should apply safeguards by ensuring that:
 - (a) the new applicant acknowledges its responsibility for establishing, maintaining and monitoring the procedures, systems and controls (including accounting and management systems) which are sufficient to enable the applicant and its directors to comply with the Listing Rules and other relevant legal and regulatory requirements on an ongoing basis and to provide a reasonable basis for the directors to make a proper assessment of the financial position and prospects of the applicant on an ongoing basis;
 - (b) the new applicant designates a competent employee, preferably within senior management, to be responsible for the procedures, systems and controls referred to in (a) above and all management decisions made in connection therewith; and
 - (c) the new applicant is responsible for evaluating the adequacy of the scope of work of the accountants and determining which recommendations of the accountants should be implemented.
20. The Code of Ethics for Professional Accountants issued by the HKICPA refers to the provision of services to an audit client:
 - (a) which involve either the design or implementation of financial information technology systems that are used to generate information forming part of a client's financial statements and which may create a self-review threat; and

- (b) in connection with the assessment, design and implementation of internal accounting controls and risk management controls which are not considered to create a threat to independence provided the auditors do not perform management functions.

In this context, the provision of services in connection with the design and implementation of financial information technology systems and internal accounting controls and risk management controls would be the subject of an engagement separate from the accountants' engagement to assist in connection with due diligence obligations, including internal controls over financial reporting.

21. In circumstances where the engaged firm is not also appointed as the auditor or reporting accountant, the firm should still ensure the firm's relationship with the listing applicant and other services performed for the listing applicant do not result in an impairment of applicable independence requirements. Where the engaged firm is also the reporting accountants, the firm will be able to, and should, state that they are independent in accordance with the Code of Ethics for Professional Accountants issued by the HKICPA. If the engaged firm is different to the reporting accountants, the engaged firm should state, in their report or in the engagement letter, whether or not that they are independent in accordance with the Code of Ethics for Professional Accountants issued by the HKICPA.
22. As noted above, the work to be undertaken by the accountants is normally done either under a joint engagement with both the new applicant and the Sponsors or under an engagement with the new applicant only with the Sponsors as a third party. It is assumed for the purposes of this Technical Bulletin that both the new applicant and the Sponsors will together determine the type of assistance to be given by the accountants. The new applicant and the Sponsors will also agree with the accountants the detailed scope of work to be performed, including that work which the Sponsors require to be performed by the accountants in connection with the Sponsors' declaration under the Listing Rules (See section C. below).
23. If the accountants are not jointly engaged there should be terms within the engagement letter with the new applicant setting out the basis on which the report is to be passed to the Sponsor, and if requested, the Stock Exchange, the SFC and other relevant regulatory authorities or as required by law or regulation. For the purpose of this Technical Bulletin, it is assumed that both the new applicant and the Sponsor will be addressees to the engagement letter and the report(s).
24. It should be understood that any engagement by the accountants to assist the new applicant and the Sponsors in connection with due diligence in respect of an initial listing application will be a private reporting engagement as distinct from a public reporting engagement. In connection with this engagement, the Sponsors will need to ensure that the engaged firm provides the assistance envisaged by the Listing Rules applicable to "Experts" (as set out in Listing Rule 3A.05), whether or not the engaged firm meets such definition under the Listing Rules.
25. An engagement for the accountants who also act as the reporting accountants to assist the new applicant and the Sponsors in connection with due diligence in respect of an initial listing application will also be a separate engagement from that described in Hong Kong Standard on Investment Circular Reporting Engagements 400 "Comfort Letters and Due Diligence Meetings", the purpose of which is to provide comfort in respect of the integrity of certain information disclosed in the investment circular, or to comment on changes in selected financial statement items subsequent to the latest period reported on in the accountants' report.

26. The scope of work in a typical due diligence assistance assignment is not designed to allow accountants to express an opinion on the state of the new applicant's controls and/or the broader due diligence performed by the Sponsors in respect of an initial listing application. The accountants do not, and could not, express such an opinion based on the procedures applied. In these circumstances, it would be inappropriate to quote from the report of the accountants or make any reference in the prospectus to the work of the accountants that could potentially be misinterpreted as the accountants providing assurance or a conclusion on either the effectiveness of internal controls or the Sponsors' due diligence procedures.
27. Against this background, this Technical Bulletin discusses the responsibilities of the directors of new applicants and the Sponsors in respect of due diligence relating to an initial listing application and the different ways in which the accountants can assist new applicants and Sponsors in assessing, inter alia, the new applicants' internal controls over financial reporting.

Part 1 – SUMMARY OF RESPECTIVE RESPONSIBILITIES OF DIRECTORS OF NEW APPLICANTS AND SPONSORS IN RESPECT OF DUE DILIGENCE OBLIGATIONS, INCLUDING INTERNAL CONTROLS OVER FINANCIAL REPORTING

B. The responsibility of directors of new applicants

28. The Listing Rules make it clear that it is the responsibility of the new applicants to establish procedures, systems and controls (including accounting and management systems) which are sufficient to enable the new applicants' directors to make a proper assessment of the financial position and prospects of the new applicant and its subsidiaries, both before and after listing.

C. The Sponsors' declaration under Listing Rule 3A.13

29. Under Listing Rule 3A.13 the Sponsor is required to declare that, among others, "Having made reasonable due diligence inquiries, we have reasonable grounds to believe and do believe that:

...

- (ii) the Company is in compliance with all the conditions in Chapter 8 of the Exchange Listing Rules (except to the extent that compliance with those rules has been waived by the Exchange in writing);
- (iii) the Company's listing document contains sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares, the financial condition and profitability of the Company at the time of the issue of the listing document;
- (iv) the information in the listing document:
 - (A) contains all information required by relevant legislation and rules; and
 - (B) is true, accurate, complete, and not misleading in all material respects, or, to the extent it consists of opinions or forward looking statements by the Company's directors or any other person, such opinions or forward looking statements have been made after due and careful consideration and on bases and assumptions that are fair and reasonable;
- (v) the Company has established procedures, systems and controls (including accounting and management systems) which are adequate having regard to the obligations of the Company and its directors under the Exchange Listing Rules and other relevant legal and regulatory requirements (in particular rules 13.09, 13.10, 13.46, 13.48 and 13.49, Chapters 14 and 14A and Appendix 16, and Part XIVA of the Securities and Futures Ordinance) and which provide a reasonable basis to enable the Company's directors to make a proper assessment of the financial position and prospects of the Company and its subsidiaries, both immediately before and after listing;

- (vi) the Company's directors collectively have the experience, qualifications and competence to manage the Company's business and comply with the Exchange Listing Rules, and individually have the experience, qualifications and competence to perform their individual roles, including an understanding of the nature of their obligations and those of the Company as an issuer under the Exchange Listing Rules and other legal or regulatory requirements relevant to their role; and
- (vii) there are no other facts bearing on the Company's application for listing of and permission to deal in its securities which, in our opinion, should be disclosed to the Exchange."

Part 2 – THE SFC AND EXCHANGE'S EXPECTATIONS OF TYPICAL DUE DILIGENCE PERFORMED BY SPONSORS

D. The SFC's expectations of Sponsors under the code of conduct

30. Paragraph 17 of the Code of Conduct sets out the key obligations of Sponsors. Paragraph 17.3(a)(i) of the Code of Conduct states that based on reasonable due diligence, a sponsor should have a sound understanding of a listing applicant, including its history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems.
31. Paragraph 17.6(d)(ii) of the Code of Conduct also notes that, regarding the preparation of the listing document, a Sponsor should:
- ...
- (ii) Achieve a thorough understanding of the listing applicant, including its business, history, background, structure and systems.

E. The Exchange's expectations of Sponsors under Practice Note 21

32. Practice Note 21 sets out the Exchange's expectations of the due diligence that Sponsors will typically perform. It should be read together with Chapter 3A of the Listing Rules and paragraph 17 of the Code of Conduct.
33. Paragraph 11 of Practice Note 21 states: "Typical due diligence inquiries in relation to the collective and individual experience, qualifications, competence and integrity of the directors include:
- (a) reviewing written records that demonstrate each director's past performance as a director of the new applicant including participation in board meetings and decision making relating to the management of the new applicant and its business;
- (b) assessing individually and collectively the financial literacy, corporate governance experience and competence generally of the directors with a view to determining the extent to which the board of the new applicant as a whole has a depth and breadth of financial literacy and understanding of good corporate governance, having regard to any code on corporate governance practices that the Exchange publishes from time to time; and
- (c) reviewing the financial and regulatory track record of each publicly listed company (this includes companies listed on other exchanges as well as on the Exchange) of which any of the new applicant's directors is or was an executive or non-executive director, for example, by reference to company disclosures, media articles and information about those companies on the website of the relevant stock exchange."
34. Paragraph 12 of Practice Note 21 states: "Typical due diligence inquiries in relation to the new applicant's compliance with the qualifications for listing include:
- (a) searching the company registry in the new applicant's place of incorporation to confirm that the new applicant is duly established in that place and that the new applicant is in compliance with its memorandum and articles of association or equivalent constitutive documents,

- (b) reviewing material financial information, including:
 - (i) financial statements of the new applicant;
 - (ii) financial statements of all subsidiaries of the new applicant and other companies that are material to the group's financial statements; and
 - (iii) the internal financial records, tax certificates and supporting documents to the tax certificates for the trading record period.

Such review would in most cases include interviewing the new applicant's accounting staff and internal and external auditors and reporting accountants and, where relevant, obtaining comfort from the new applicant's external auditors or reporting accountants based upon agreed procedures; and

- (c) assessing the accuracy and completeness of the information submitted by the new applicant to demonstrate that it satisfies the trading record requirement."

35. Paragraph 13 of Practice Note 21 states: "Typical due diligence inquiries in respect of each new applicant and the preparation of its listing document and supporting information include:

- (a) assessing the financial information to be published in the listing document including:
 - (i) obtaining written confirmation from the new applicant and its directors that the financial information (other than that already reported upon by a reporting accountant) has been properly extracted from the relevant underlying accounting records; and
 - (ii) being satisfied that the confirmation referred to at paragraph (i) has been given after due and careful inquiry by the new applicant and its directors;
- (b) assessing the new applicant's performance and finances, business plan and any profit forecast or estimate, including an assessment of the reasonableness of budgets, projections and assumptions made when compared with past performance, including historical sales, revenue and investment returns, payment terms with suppliers, costs of financing, long-term liabilities and working capital requirements. This would normally include interviewing the new applicant's senior management and would often involve interviewing the new applicant's major suppliers and customers, creditors and bankers;
- (c) assessing whether there has been any change since the date of the last audited balance sheet included in the listing document that would require disclosure to ensure the listing document is complete and not misleading;
- (d) assessing whether it is reasonable to conclude that the proceeds of the issue will be used as proposed by the new applicant, taking into account the outcome of the Sponsor's assessment of, in particular, the new applicant's existing cash and liquid reserves, projected liabilities, working capital requirements and expenditure controls;
- (e) undertaking a physical inspection of material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets (for

example, livestock or crops) used or to be used in connection with the new applicant's business;

- (f) reaching an understanding of the new applicant's production methods;
 - (g) reaching an understanding of the manner in which the new applicant manages its business, including as relevant actual or proposed marketing plans, including distribution channels, pricing policies, after-sales service, maintenance and warranties;
 - (h) reviewing the business aspects of all contracts material to the new applicant's business;
 - (i) reviewing legal proceedings and other material disputes that are current or recently resolved (for example, resolved in the previous 12 months) and in which the new applicant is involved, and all proceedings or material disputes the new applicant knows to be contemplated and which may involve the new applicant or one of its subsidiaries;
 - (j) analysing the business aspects of economic, political or legal conditions that may materially affect the new applicant's business;
 - (k) considering the industry and target markets in which the new applicant's business has principally operated and is intended to principally operate, including geographical area, market segment and competition within that area and/or segment (including existing and potential principal competitors and their relative size, aggregate market share and profitability);
 - (l) assessing whether there is appropriate documentation in place to confirm that the material assets, whether owned or leased, including property, plant, equipment, inventory and biological assets used or to be used, in connection with the new applicant's business, are appropriately held by the new applicant (for example, reviewing the relevant certificates of title and rights of land use);
 - (m) assessing the existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights of the new applicant;
 - (n) reaching an understanding of the technical feasibility of each new product, service or technology developed, being developed or proposed to be developed under the new applicant's business plan that may materially affect the new applicant's business; and
 - (o) assessing the stage of development of the new applicant's business and assessing the new applicant's business plan and any forecasts or estimates, including reaching an understanding of the commercial viability of its product(s), service(s) or technology, including an assessment of the risk of obsolescence as well as market controls, regulation and seasonal variation."
36. Paragraph 15 of Practice Note 21 states: "Typical due diligence inquiries in relation to the new applicant's accounting and management systems and in relation to the directors' appreciation of their and the new applicant's obligations include:
- (a) assessing the new applicant's accounting and management systems that are relevant:

- (i) to the obligations of the new applicant and its directors to comply with the Exchange Listing Rules and other legal and regulatory requirements, in particular the financial reporting, disclosure of price sensitive information and notifiable and connected transaction requirements; and
- (ii) to the directors' ability to make a proper assessment of the financial position and prospects of the new applicant and its subsidiaries, both immediately before and after listing.

This assessment should cover the new applicant's compliance manuals, policies and procedures including corporate governance policies and any letters given by the reporting accountants to the new applicant that comment on the new applicant's accounting and management systems or other internal controls; and

- (b) interviewing all directors and senior managers with key responsibilities for ensuring compliance with the Exchange Listing Rules and other legal and regulatory requirements (including the staff responsible for the accounting and financial reporting function, company secretary and any compliance officers) to assess:
 - (i) their individual and collective experience, qualifications and competence; and
 - (ii) whether they appear to understand relevant obligations under the Exchange Listing Rules and other relevant legal and regulatory requirements and the new applicant's policies and procedures in respect of those obligations".

Part 3 – DISCUSSION OF TYPICAL TYPES OF ASSISTANCE TO BE PROVIDED BY ACCOUNTANTS

37. The focus of the guidance contained in this Technical Bulletin is on how accountants can provide assistance to new applicants and/or Sponsors in connection with internal controls over financial reporting and the broader due diligence performed by Sponsors in respect of an initial listing application.
38. In the context of the Listing Rules, Practice Note 21 and the Code of Conduct, such assistance typically takes the form of either a long form report or agreed-upon procedures engagement as described in sections F, G and H. Another form of assistance could be an engagement to express assurance on internal controls over financial reporting. It is not currently a common market practice in Hong Kong for accountants to undertake separate assurance engagements in respect of new applicants' internal controls over financial reporting in view of the relative immaturity of many new applicants' systems of internal controls over financial reporting. As a result, in many cases, it may not be possible for accountants to give an unqualified opinion. It is also noted that assurance in respect of a new applicant's internal controls over financial reporting is not typically required or sought by Sponsors (or equivalent) and new applicants prior to listing. Engagements to express assurance on internal controls over financial reporting are discussed in Appendix 4.
39. Practice Note 21 makes it clear that Sponsors are required to take responsibility for:
- (a) making their own due diligence enquiries;
 - (b) making their own assessment; and
 - (c) reaching their own conclusion for the purposes of their declaration under the Listing Rules.

Whilst a long form report, agreed-upon procedures assignment or an assurance report from the accountants can provide one of a number of sources of information to Sponsors to assist them in making their declaration, it should be understood that it is not possible for the accountants to stand in the place of the Sponsors as concerns their responsibilities under the Listing Rules.

F. Long form report – internal controls over financial reporting

40. There is no professional standard in Hong Kong covering long form report engagements. Accordingly, the scope of work to be performed and the form of the report to be issued is a matter to be agreed between the new applicant, the Sponsors and the accountants.
41. The accountants would normally expect to gain an understanding of the new applicant's existing internal controls over financial reporting and to include in their report a commentary thereon. The commentary might reflect a description of any detailed procedures performed on the design and implementation of internal controls over financial reporting and details of the findings. The agreed scope of work could also involve the accountants in carrying out tests on the operating effectiveness of internal controls over financial reporting. The purpose of such testing, where it is undertaken, is to report the findings for the information of the new applicant and the Sponsors and not to report any conclusion about control activities as a whole or to express any form of assurance.

42. The final scope of the long form report and the specific matters to be covered will vary from case to case. Appendix 3 illustrates matters that may be considered for the scoping of a long form report covering internal controls over financial reporting, but this list should not be regarded as exhaustive and it is not industry specific.
43. The work will result in commentary in the long form report appropriate to the scope of work as agreed with the Sponsors and the new applicant. The accountants should set out in their report a description of any internal control deficiencies which come to their attention during the course of their work and provide recommendations for measures to be taken to address such deficiencies.

In addition, all relevant business processes, operational activities and financial control procedures are dependent for their effectiveness on the diligence and propriety of those responsible for operating them, and are capable of being overridden by management. Hence, the accountants will not be in a position to provide any assurance over the new applicants' internal controls over financial reporting and thus neither the Sponsors nor the new applicant should rely on the long form report to provide such assurance.

KEY POINTS
<p>Scope</p> <ul style="list-style-type: none"> ▪ Scoping may be performed with reference to paragraph 15 of Practice Note 21, the Code of Conduct and at a high-level in terms of general areas of internal controls over financial reporting (as indicated in Appendix 3 of this Technical Bulletin) to be considered by the accountants. ▪ Can combine review and commentary with detailed testing. <p>Report</p> <ul style="list-style-type: none"> ▪ Narrative report format. ▪ Commentary on internal control and processes and identification and classification of any control deficiencies identified. ▪ Recommendations for improvement (to the extent that they come to the attention of the accountants within the scope of their work). ▪ Findings of any detailed testing performed. ▪ No assurance as to the effectiveness of the new applicant's internal control activities. <p>Follow-up</p> <ul style="list-style-type: none"> ▪ If applicable, a follow-up visit to determine and report on whether recommendations have been implemented.

G. Agreed-upon procedures

44. Agreed-upon procedures engagements are carried out with reference to the principles outlined in Hong Kong Standard on Related Services 4400 "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" issued by the HKICPA and in accordance with the terms of engagement. The objective of an agreed-upon procedures engagement is "for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties (such as a Sponsor) have agreed and to report on factual findings".
45. In an agreed-upon procedures engagement, procedures of an audit nature are performed, the scope of which should be agreed between the accountants, the new applicant and the Sponsors. This requirement to scope the procedures to be

performed at a detailed level distinguishes an agreed-upon procedures engagement from a long form report engagement where scoping is typically done at a high-level in terms of the general areas of internal controls over financial reporting to be considered by the accountants.

46. The accountants provide a report of the factual findings resulting from the agreed-upon procedures, no assurance is expressed and no views on the materiality of deficiencies are provided or recommendations as to how the deficiencies can be addressed. The Sponsor would therefore need to make its own assessment of the materiality of the deficiencies identified and make appropriate recommendations for rectification. It is for the new applicants and the Sponsors to assess for themselves the procedures and findings reported on by the accountants and to draw their own conclusions. The agreed-upon procedures report will be addressed to the new applicant and to the Sponsors to the extent that the Sponsors are a party to, and sign, the engagement letter. As noted in paragraph 23, there should be terms within the engagement letter with the new applicant setting out the basis on which the report is to be passed to the Stock Exchange, the SFC and other relevant regulatory authorities or as required by law or regulation, if required.

KEY POINTS
<p>Scope</p> <ul style="list-style-type: none"> ▪ Specific procedures of an audit nature agreed-upon between the new applicant, the Sponsors and the accountants. <p>Report</p> <ul style="list-style-type: none"> ▪ Report of factual findings based on the specific procedures performed which may encompass providing commentary and identification of any control deficiencies identified. ▪ No assessment of the materiality of deficiencies is provided, ▪ No assurance as to the effectiveness of the new applicant's internal control activities. <p>Follow-up</p> <ul style="list-style-type: none"> ▪ If applicable, a follow-up visit to report on status of the control deficiencies identified.

H. Long form report – comprehensive review

47. As noted in paragraph 40, there is no professional standard in Hong Kong covering long form report engagements. Accordingly, the scope of work to be performed and the form of the report to be issued in respect of the Sponsor's due diligence requirements is a matter to be agreed between the new applicant, the Sponsors and the accountants.
48. The definition of the scope of the long form report engagement is usually an iterative process leading up to the time of the IPO submission. The precise scope and the particular aspects of work requested of the accountant will be tailored to the circumstances of the listing application and will be specified in the engagement letter.
49. In performing an engagement to prepare a long form report that is not limited to internal controls over financial reporting, the accountants would normally expect to gain an understanding of the new applicant's history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems, and the details of directors and key senior management and to include in

their report a commentary thereon. The commentary might reflect a description of any detailed procedures performed on the design and implementation of internal controls over financial reporting, existing procedures and practices over operations and structure, procedures and systems, directors and key senior management and details of the findings.

50. The final scope of the long form report engagement and the specific matters to be covered will vary from case to case. Further to the indicative scope of work for internal control over financial reporting set out in Appendix 3 of this Technical Bulletin, other matters which may be expected to be included are:

- Strategy / prospects
- History and description of business
- Management and employees
- Directors and senior management
- Products and marketing
- Production, purchasing, and research and development
- Trading results
- Assets and liabilities

The above list is illustrative only. Not all areas may be relevant or significant to every business and other matters may be included as requested by the Sponsors and/or the new applicant.

51. The work will result in commentary in the long form report appropriate to the scope of work as agreed with the Sponsors and the new applicant. In addition, all relevant business processes, operational activities and financial control procedures are dependent for their effectiveness on the diligence and propriety of those responsible for operating them, and are capable of being overridden by management. Hence, the accountants will not be in a position to provide any assurance over the new applicants' processes or controls and thus neither the Sponsors nor the new applicant should rely on the long form report to provide such assurance.

KEY POINTS
<p>Scope</p> <ul style="list-style-type: none"> ▪ Scoping is defined with reference to the relevant paragraphs within Practice Note 21 and the Code of Conduct. Areas to be covered are likely to include internal controls over financial reporting (as illustrated in Appendix 3 of this Technical Bulletin) and a broader scope as appropriate to the circumstances (as indicated in paragraph 50 of this Technical Bulletin). <p>Report</p> <ul style="list-style-type: none"> ▪ Narrative report format. ▪ Commentary in the long form report appropriate to the scope of work as agreed and description of any deficiencies identified. ▪ Recommendations for improvement (to the extent that they come to the attention of the accountants within the scope of their work). ▪ No assurance as to the effectiveness of the new applicant's processes or controls. <p>Follow-up</p> <ul style="list-style-type: none"> ▪ If applicable, a follow-up visit to determine and report on whether recommendations have been implemented.

Part 4 – ASSESSING AND REPORTING DEFICIENCIES

I. Assessing and reporting deficiencies

52. Paragraph 17.3(b)(ii) and (iii) of the Code of Conduct sets out the SFC's expectation regarding a Sponsor's obligation to assist in remedying any material deficiencies identified or otherwise make disclosures in respect of such deficiencies:
- Sponsors should provide adequate advice and recommendations to assist the listing applicant to remedy any material deficiencies that are identified in relation to its operations and structure, procedures and systems, or directors and key senior managers; and
 - where these material deficiencies cannot be remedied prior to the submission of a listing application, adequate disclosure should be made in the listing application, including the nature of the deficiencies, reasons for non-rectification and remedial actions taken or to be taken.
53. Key controls could be deemed to be missing, deficient in design or not operating effectively if exceptions are identified during managements internal assessment of its controls and procedures, or during the Sponsor's due diligence procedures (including as a result of assistance provided by the accountants).
54. The Code of Conduct clarifies "material deficiencies" as those "deficiencies in relation to a listing applicant which would reasonably be expected to affect the consideration of the applicant's suitability by the regulators or which, if disclosed, would reasonably be expected to materially and adversely affect an investor's decision".
55. Management of the listing applicant and the Sponsors need to decide whether any deficiencies identified by themselves, or others such as the accountants, in relation to new applicant's operations, structure, procedures and systems, directors and key senior managers, and internal controls over financial reporting, represent a "material deficiency", as defined above.
56. In terms of internal controls over financial reporting, such a deficiency would indicate that the controls do not provide a reasonable level of assurance that there will not be material errors in future financial reporting. In order to determine whether a material deficiency exists, each control deficiency is assessed in turn to determine the likely effect of the control deficiency and its potential magnitude. Each deficiency is assessed to determine whether it is individually "material" as defined in paragraph 54 above. Then, management needs to determine whether a combination of deficiencies is likely to represent a risk (i.e., an aggregated risk) that is material.
57. In the context of assessing control deficiencies for the purposes of this Technical Bulletin, an "other control deficiency" is a deficiency, or a combination of deficiencies, that is less severe than a material deficiency yet important enough to merit attention by those responsible for operations, structure, procedures and systems, directors and key senior managers, and oversight of the company's financial reporting. "Observations for improvement" are those matters that would not result in a control weakness, but if remedied, may improve the efficiency of processes.

58. In long form engagements, the accountants would set out in their report any deficiencies identified as a result of their work performed, and would identify those deficiencies that, in their view represent either material deficiencies or other control deficiencies over the listing applicant's internal controls over financial reporting, based on the criteria specified in paragraphs 56 to 57 of this Technical Bulletin. The nature of these engagements is such that, whilst it may be possible to examine in some detail a particular element of particular operations, structure, procedures and systems, or directors and key senior managers of the listing applicant, it will not be possible to identify and report all deficiencies that may exist, or report any conclusion about the listing applicant's processes and controls as a whole. No assessment of the materiality (or relative level of significance or risk) of deficiencies is provided in the report of factual findings for agreed-upon procedures engagements.
59. It is normal practice for the accountants to assist in performing a follow up visit to review the implementation of measures adopted to address those identified deficiencies. The accountants would normally expect to assess the design, or even the implementation, of those remediated processes or controls. In terms of newly implemented controls, however, it may not be possible to assess the operating effectiveness of such controls because of the short period over which such new measures would have been operating. This may, therefore, lead to the need to disclose control deficiencies at the time of the listing application, even though action has been taken to remediate such deficiencies.

Part 5 – OTHER MATTERS

J. Meetings with Sponsors

60. It is normal practice for the Sponsors to discuss the content of a report that will form part of a Sponsor's due diligence procedures in respect of a listing application with the accountants. Where the accountants provide oral comments, the comments are not intended to have any greater significance than explanations of matters contained in the report. Reliance may be placed on information set out in the report and on matters dealt with in oral comments only on the basis of the terms and conditions agreed in the engagement letter. Generally, the accountant should answer queries raised at meetings on an informal basis but the Sponsors should neither act nor refrain from acting on the basis of such informal answers unless and until they are confirmed in writing by the accountant, whether in a final report or otherwise. The engagement letter should include a term to the effect that in the absence of such written confirmation the accountant shall have no liability to the Sponsor or Listing Applicant in contract or in tort (including negligence) for oral statements other than for an statement known to be false or misleading when made and made with intent to deceive.
61. The terms described in paragraph 60 above are not intended to prejudice the Sponsors' ability to rely on a non-recourse basis (meaning without any liability on the accountant's part except for oral statements known to be false or misleading when made and made with intent to deceive) on any comments the accountant may provide orally, either in the context of establishing or seeking to establish any due diligence defence in connection with any court, arbitral, regulatory or administrative proceedings or otherwise for the purposes of resolving either actual or potential proceedings, investigations, claims or disputes in respect of a prospectus or otherwise in connection with the offering.

Appendix 1

Matters to be considered over internal controls over financial reporting in respect of due diligence obligations

A. The internal control process over financial reporting

1. It is not possible nor is it necessary to describe in detail in this Technical Bulletin the concept and scope of internal control. Such a detailed description may be found in "Internal Control and Risk Management - A Basic Framework".⁴ It is, however, worthwhile to characterise briefly the internal control process over financial reporting.
2. The internal control process over financial reporting begins with management setting financial reporting objectives relevant to the new applicant's particular business activities and circumstances. Once set, management identifies and assesses a variety of risks impacting those objectives, determines which risks could result in a material misstatement in financial reporting and determines how the risks should be managed through a range of control activities. Management implements policies and procedures to capture, process and communicate information needed for financial reporting and other components of the internal control system. All this is done in the context of the new applicant's control environment, which is shaped and refined as necessary to provide the appropriate tone at the top of the organisation and related attributes. These components all are monitored to help ensure that controls continue to operate properly over time.⁵

B. Effective internal controls over financial reporting

3. The Listing Rules refers to the ability of the directors to "...make a proper assessment of the financial position and prospects of the new applicant...". Accordingly, as part of their readiness deliberations both new applicants and Sponsors are concerned with the reliability of the new applicant's internal controls over financial reporting.
4. Relevant principles in achieving the objective of reliability of financial reporting are set out in Appendix 2. These principles are used to assist the new applicant and Sponsors and the accountants in determining the financial control objectives to be addressed by the accountants' work. While the financial control objectives vary among different companies depending on the industry, size, organisational structure, culture, and management philosophy, these principles remain fundamental to all companies.

C. Scoping

5. Scoping typically involves the new applicant, the Sponsors and the accountants working closely together to identify the key risks that the new applicant faces and the corresponding financial control objectives and control activities that are significant to mitigate those risks. Since each new applicant is unique and faces different risks, the internal controls to be considered are different among applicants. A further complexity arises for new applicants that carry on business in multiple locations with different control environments and internal control systems. There is no "one-size-fits-all" set of control objectives and control activities applicable to all new applicants.

⁴ "Internal Control and Risk Management – A Basic Framework" issued by the HKICPA in June 2005.

⁵ The content of this paragraph is based on "Internal Control over Financial Reporting - Guidance for Small Public Companies Volume 1: Executive Summary" published by the Committee of Sponsoring Organizations of the Treadway Commission in 2006.

6. The declaration of the Sponsors under the Listing Rules will be based on their own due diligence enquiries and assessment of the areas of internal control that are of concern to them. The Sponsors will need to work closely with the accountants to ensure that the work of the accountants is focused on these identified areas of concern. It is for the Sponsors to satisfy themselves that the scope of work to be carried out by the accountants will, together with the Sponsors' own enquiries, be sufficient for the purposes of the Sponsors' declaration under the Listing Rules.

D. Considering design, implementation and operating effectiveness

7. Engagements in connection with the readiness of a new applicant's internal controls over financial reporting typically involve consideration of the design, implementation and/or operating effectiveness of control activities.
8. Control activities can be said to be properly designed when, individually or in conjunction with other control activities, they contribute to the meeting of control objectives. So far as design effectiveness is concerned, it is irrelevant whether the control procedures have or have not been implemented. Instead, accountants gain an understanding of the design of the control procedures through inquiry and review of documentation in order to determine whether relevant control objectives are properly addressed by those procedures if they are to be implemented.
9. Implementation concerns whether control activities are implemented as designed. When considering implementation effectiveness, the accountants perform walkthrough procedures and inquiries which are corroborated with observation, review of documentation, or re-performance, so as to determine whether the control activities are implemented as designed. An assessment of implementation effectiveness should not be carried out where the design of the control procedures fails to meet the control objectives.
10. Operating effectiveness is concerned with whether control activities are operated as designed for a period of time. Operating effectiveness is assessed through detailed testing covering an elapsed period of time. This contrasts with the testing of implementation which is performed as at a point in time.

Appendix 2

Basic principles in achieving effective internal controls over financial reporting

Reproduced below are seventeen basic principles in achieving effective internal controls over financial reporting set out in "Internal Control - Integrated Framework" ⁶ representing the fundamental concepts associated with, and drawn directly from, the five components of the COSO Framework ⁷.

Control Environment

1. **Integrity and Ethical Values** – The organisation demonstrates a commitment to integrity and ethical values.
2. **Board of Directors** – The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. **Management's Philosophy, Operating Style and Organisational Structure** – Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives ⁸.
4. **Human Resources** – The organisation demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives.
5. **Authority and Responsibility** – The organisation holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

Risk Assessment

6. **Financial Reporting Objectives** – The organisation specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
7. **Financial Reporting Risks** – The organisation identifies risks to the achievement of its objectives across the entity and analyses risks as a basis for determining how the risks should be managed.
8. **Fraud Risk** – The organisation considers the potential for fraud in assessing risks to the achievement of objectives.
9. **Integration with Risk Assessment** – The organisation identifies and assesses changes that could significantly impact the system of internal control.

⁶ "Internal Control – Integrated Framework: Executive Summary" published by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

⁷ "Internal Control – Integrated Framework: Executive Summary, Framework and Appendices, and Illustrative Tools for Assessing Effectiveness of a System of Internal Control" issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

⁸ The COSO Framework is designed to be used by organisations to assess the effectiveness of the system of internal control to achieve objectives as determined by management, including operations, reporting and compliance objectives.

Control Activities

10. **Selection and Development of Control Activities** – The organisation selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
11. **Information Technology** – The organisation selects and develops general control activities over technology to support the achievement of objectives.
12. **Policies and Procedures** – The organisation deploys control activities through policies that establish what is expected and procedures that put policies into action.

Information and Communication

13. **Internal Control Information** – The organisation obtains or generates and uses relevant, quality information to support the function of internal control.
14. **Internal Communication** – The organisation internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
15. **External Communication** – The organisation communicates with external parties regarding matters affecting the functioning of internal control.

Monitoring Activities

16. **Ongoing and Separate Evaluations** – The organisation selects, develops, and performs ongoing and/or separate evaluations to ascertain whether components of internal control are present and functioning.
17. **Reporting Deficiencies** – The organisation evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Appendix 3

Illustrative scope of work in connection with due diligence assistance for internal controls over financial reporting

The final scope of a long form report engagement and the specific matters (areas of focus) to be covered will vary from case to case. The areas of focus illustrated in this Appendix represent matters that may be considered for inclusion in the scope of an assignment in connection with providing due diligence assistance for internal controls over financial reporting.

- (a) The procedures performed by the accountant over the system of internal controls will be undertaken with reference to the COSO framework (as set out in Appendix 2). In respect of the illustrative scope of work the accountant will:
- (i) Understand how a control procedure is undertaken through discussions with management, and review relevant policies and procedures;
 - (ii) Consider and comment on the design, implementation and operating effectiveness of control procedures in the agreed scope of work.

The new applicant and the Sponsors will need to agree with the accountants the extent and period of coverage for the testing of controls. The accountant will not necessarily cover all relevant periods for each and every control that is tested.

- (iii) Draw to the new applicant and the Sponsor's attention any material or other internal control deficiencies which come to the accountant's attention based on the procedures performed; and
 - (iv) Provide recommendations to address the identified internal control deficiencies.
- (b) The illustrative list of areas to be covered, as set out below, should not be regarded as exhaustive and it is not industry specific.

I. Internal Control at the Entity Level

1. Control Environment

1.1 Integrity and ethical values

- Code of conduct and other practices regarding acceptable business practice or expected standards of ethical and moral behavior (including dealings in securities for employees, management and directors)
- Management of conflict of interest
- Determination of management's remuneration
- Whistleblower program and other misconduct detective measures
- Approach to compliance with the Rules Governing of the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "Listing Rules"), including the Code on Corporate Governance Practices

1.2 Board of directors and board committees

- Independence, experience, roles and responsibilities of the Board of Directors
- Composition and experience of members of each committee
- Board and committee meetings
- Terms of reference for each committee
- Process for informing the board of directors of significant issues

- Communication and procedures of meetings between each committee, management and board of directors
 - Declaration of interest of directors
- 1.3 Management's philosophy and operating style
- Achieving effective financial reporting, including development of accounting estimates and accounting policies
 - Evaluation of potential investments/ventures (including policies and procedures, future strategy and planning process)
 - Management incentive program
 - Senior management's attention and discussion on governance, risk and control matters
- 1.4 Organizational structure
- Description of business units and their responsibilities
 - Reporting lines (including interaction between senior management and operating management)
 - Segregation of legal entities and evaluation process for changes in organisational structure in light of changes in the business or industry
 - Delegation of authority
- 1.5 Financial reporting competencies
- Staffing, experience and qualifications of financial reporting and related oversight roles
 - Provision of training relating to financial reporting
 - Procedures for evaluating the departure of management and supervisory personnel
- 1.6 Authority and responsibility
- Communication of job description with role and level of authority
 - Delegation and assignment of the level of authority and responsibility of key functional divisions
 - Information of ownership and management and access of authority level
 - Policies and Procedures on management override
- 1.7 Human resources
- Employee feedback mechanism
 - Recruitment and termination policies and procedures
 - Staff recruitment and selection
 - Performance evaluation, and staff promotion, retention and compensation, including senior management compensation
 - Training and development
 - Compliance with contractual and legal requirements
 - New/ amended employment contracts within to-be-listed entity
 - Human resources manual
- 1.8 Legal and regulatory compliance
- With respect to financial reporting (i.e. process relating to identifying and managing contingent liabilities etc.)
 - Internal control system and procedures including accounting and management system to ensure compliance with the Listing Rules in relation to financial reporting, disclosure of notifiable transaction requirements, including detection, prevention and correction of non-compliance

2. Risk Assessment

2.1 Setting objectives

- Business mission objectives, entity-wide objectives and activity-level objectives
- Business planning
- Financial reporting objectives

2.2 Risk assessment and management

- Risk assessment and management process and reporting
- Legal and regulatory compliance
- Fraud identification, prevention and reporting process
- Whistleblowing procedures
- Procedures for identifying and reacting to changing environment (including managing changes)
- Development of action plan to mitigate risk
- Ongoing monitoring of risks and operating environment
- Actions to be taken to address financial reporting risks identified from risk assessment
- Business contingency plan

3. Control Activities

3.1 Implementation of policies/practices and procedures of significant business processes (see Section II below)

3.2 Procedures for entering into material contracts and other legal commitments

4. Information and Communication

4.1 Forecasting and budgeting

- Corporate planning
- Budgeting preparation
- Procedures to maintain a rolling budget and forecast
- Variance analysis

4.2 Management reporting framework and procedures

4.3 Internal communication

- Upstream and downstream communication mechanism within the organisation
- Communication in terms of frequency, timeline, methods and sources of information
- Procedures to identify and monitor confidential or sensitive information (including prior to public announcement)
- Monitoring and identification of notifiable and connected transactions (Chapters 14 and 14A of Listing Rules)

4.4 External communication

- Communication policy with external parties, and follow up action by management
- Distribution of annual/ interim reports and publication of results announcements (Listing Rules 13.46, 13.48 and 13.49)
- Handling and monitoring of inside information/ sensitive information/ confidential information prior to public announcement (Listing Rule 13.09 and Part XIVA of the SFO)
- Responding to enquiries from regulatory authorities (Listing Rule 13.10)

- Monitoring and handling of information leakage (including sensitive information)

4.5 Confidentiality and Data Protection

- Policies and procedures for access to and maintenance of sensitive information
- Data protection policies
- Maintenance and protection of trade secrets and confidential information, including lists of customers and suppliers and others sensitive commercial information

5. Monitoring

5.1 Management monitoring activity (e.g. management reporting, analysis and review)

5.2 Internal audit and investigation functions (including remedial action in response to departures from approved policies/practices and procedures)

- Function, responsibilities and authority of the internal audit department
- Liaising with external auditors
- Management monitoring activities (management reporting, analysis and review)
- Specific monitoring initiatives
- Evaluation of internal control weaknesses
- Implementation of internal control policies, practices or procedures

5.3 Channels for reporting deficiencies/irregularities

5.4 Management letter points issued by external auditors

5.5 Regulatory compliance management

5.6 Reporting of internal control deficiencies

5.7 Compliance with laws and regulations (including relevant Listing Rules)

II. Internal control at the process level

1. Sales, accounts receivable and collection

- Policies and procedures
- Managing and Processing customer account opening
- Customer selection and managing customer information
- Managing customer credit and credit control
- Pricing/discount policies
- Managing and processing sales orders and returns
- Logistics arrangement and sales fulfillment
- Accounts receivable monitoring, bad debt provision and write-off
- Processing receipts
- Segregation of duties over revenue management process

2. Procurement, accounts payable and payment

- Policies and procedures
- Selection, management and monitoring of suppliers
- Maintenance of supplier master file
- Supplier selection process and data management
- Managing, processing and approval of purchase requisition and purchase orders
- Processing accounts payable and approval of payment

- Segregation of duties over the procurement management and payable process
- 3. Inventory management, including logistics**
- Policies and procedures
 - Inventory movement management (receive, transfer, dispatch)
 - Logistics arrangement between suppliers/company
 - Physical safeguards over Inventory
 - Inventory counting and valuation procedures
 - Segregation of duties over inventory management process
 - Recording and reconciliation of inventory
 - Impairment and write-offs
- 4. Production and costing**
- Production planning and management
 - Costing management
 - Monitoring, reporting and follow-up of supply interruption
- 5. Human resources (HR) and payroll**
- Recruitment policies and procedures (hiring and termination process)
 - Calculating and processing of payroll
 - Managing payroll records
 - Segregation of duties over the HR & payroll management process
 - Pension plans and occupational schemes policies and contributions
 - Housing, medical and other allowances determination and approval
 - Employee bonus determination and approval
 - Performance evaluation process
 - Compliance monitoring with labour laws and regulations
- 6. Fixed assets**
- Policies and procedures
 - Acquisition of fixed assets (including vendor selection and contract management)
 - Capitalisation of assets under construction (including staff costs capitalisation)
 - Depreciation of fixed assets
 - Disposal/transfer of fixed assets
 - Maintenance of fixed assets (including valuation and impairment assessment)
 - Managing and safeguarding fixed assets
 - Maintenance of fixed assets master file
 - Segregation of duties over fixed assets management process
- 7. Cash and treasury management**
- Policies and procedures
 - Managing liquidity
 - Managing investment
 - Managing borrowing (including financing covenant compliance, if applicable)
 - Opening and maintaining of bank accounts
 - Managing financial instruments e.g. derivatives, hedging, foreign exchange (if applicable)
 - Cash flow forecasting
 - Physical cash management and bank reconciliation
 - Policy on cash advances to directors and employees
 - Segregation of duties over cash management and treasury process
 - Settlement - payments and receipts (financial/ treasury related)

8. Insurance

- Safeguarding fixed assets
- Safeguarding inventory
- Protecting and compensating employees
- Third party litigation
- Product liability

9. Financial reporting and disclosure controls

- Financial organisation, competencies and reporting relationships (including Accounting and Finance, Treasury and Tax Functions)
- Accounting policies and procedures development
- Financial approval and reporting structure
- Periodic Financial Statement Close Procedures
- Key Accounts Reconciliation (e.g. Bank reconciliation, intercompany balances reconciliation)
- Calculation and Recording of Estimate, Accruals and Non-routine Transactions
- Consolidation and elimination
- Reporting and Disclosures (including Related Parties and Connected Party Transactions)
- Financial statements preparation (including Procedures for Capturing Information for Financial Statement Disclosure and Selection and Application of Accounting Policies (Chapter 4 and Appendix 16 of the Listing Rules))
- Off-balance sheet and contingent liability monitoring and reporting
- Financial analysis and variance analysis
- Corporate planning
- Performance measurement
- Budgeting process and budgetary control, monitoring and updates
- Segregation of duties over the financial reporting process
- Ongoing training and development

10. Taxes

- Tax filing
- Tax compliance
- Tax disputes handling procedures

11. IT General Controls

- IT security policies and administration procedures
- Program change management
- Logical access and security control
- Backup and disaster recovery plan
- Policies and procedures
- Information resource strategy and planning
- Business continuity planning
- Information systems operations
- Application systems and database implementation and maintenance
- Systems software, hardware and network support
- Monitoring of software license
- Access and security control

Appendix 4

Expressing assurance on internal controls over financial reporting

1. Assurance engagements are performed in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" ("HKSAE 3000") issued by the HKICPA and in accordance with the terms of engagement.
2. In an assurance engagement the accountants express an overall conclusion (either in a positive or negative form of expression) in terms of:
 - (a) the effectiveness of the design of internal controls activities;
 - (b) the effectiveness of the design and the implementation of internal controls activities; or
 - (c) the effectiveness of the design, the implementation and operating effectiveness of internal controls activities.
3. Assurance engagements may take the form of reasonable assurance engagements or limited assurance engagements. A reasonable assurance engagement includes the expression of a positive form of opinion by the accountants, based on systematic and thorough evidence-gathering procedures. The evidence-gathering procedures to be carried out within the scope of a limited assurance engagement will be less extensive and, accordingly, the accountants will express a negative form of opinion.
4. In order to conclude on the effectiveness of internal controls for design, implementation or operating effectiveness, the significance of each control deficiency found during the course of assessment is evaluated individually and in the aggregate, and the likelihood that the deficiency, or a combination of deficiencies, could result in a misstatement and the magnitude of the potential misstatement are considered. In practice, considerable judgment on the part of the accountants is required to determine whether the internal controls over financial reporting are effective, and therefore there is always risk of the practitioner stating that the internal controls over financial reporting are effective when in fact they are not and vice versa.
5. It is not currently market practice in Hong Kong for accountants to undertake separate assurance engagements in respect of new applicants' internal controls over financial reporting for Practice Note 21 purposes. Reasons for this include the following:
 - (a) It would only be advisable to embark on an engagement to provide assurance if management of the new applicant is able to represent, as appropriate, that relevant control activities have been effectively designed and implemented and have operated effectively throughout a defined and elapsed period such that an unqualified assurance opinion can reasonably be expected to be issued on the new applicant's internal controls over financial reporting. A qualified opinion is unlikely to be viewed as valuable by users. In many cases, however, management will not be in a position to make such representation in view of the relative immaturity of the new applicant's system of internal controls over financial reporting (for the reasons described in paragraph 10 of the Technical Bulletin) such that there will be no basis for such an expectation that an unqualified opinion can be given. Where the accountants have reason to believe that a qualified opinion would be necessary were an assurance

engagement to be undertaken, they should communicate this to the new applicant and the Sponsors.⁹

- (b) Assurance in respect of new applicants' internal controls over financial reporting is not typically required or sought by Sponsors (or equivalent) and new applicants in other jurisdictions prior to listing.
- (c) The extent of work (and as a result cost) involved in undertaking an assurance engagement is likely to be significantly greater than for a long form report or agreed-upon procedures engagement.

6. In practice, accountants should consider other reporting responsibilities, including the appropriateness of communicating relevant matters of governance interest arising from the assurance engagement with the management and/or directors of the listing applicant.

"Relevant matters of governance interest" are those that arise from the assurance engagement and, in the accountant's opinion, are both important and relevant to the management and/or directors of the listing applicant. Relevant matters of governance interest include only those matters that have come to the attention of the accountant while performing the assurance engagement. If the terms of the engagement do not specifically require it, the accountant is not required to design procedures for the specific purpose of identifying matters of governance interest.

KEY POINTS	
Scope	<ul style="list-style-type: none">▪ In order for the accountants to issue an opinion in the report (either a positive or negative form of expression), the extent of work is at least sufficient for the accountants to obtain a meaningful level of assurance as the basis for the opinion.▪ While there is no specific elapsed period that is required before the assessment, the control procedures to be tested should at least be operating over the testing period and long enough so that sufficient samples could be obtained for the testing.
Report and management letter	<ul style="list-style-type: none">▪ Assurance as to the effectiveness of the internal controls systems.▪ Identification of any control deficiencies identified.▪ Recommendations for improvement (to the extent that they come to the attention of the accountants within the scope of their work).

⁹ An assurance engagement may be undertaken when the new applicant has implemented and operated internal controls over financial reporting for a defined and elapsed period of time (e.g. as may be the case for a spin-off of a business from an existing listed company).