How To Deal With Rule 719(1) And 1207 (10) Of The SGX Listing Manual

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With effect from 29 September 2011 SGX updated the listing manual to bring into the listing requirements both the need for adequate internal control s and a specific statement from the board on the adequacy of the internal controls, which must be included in the Annual Report.

Many of us, who are directors of listed entities, were caught by surprise as the implementation requirement was almost immediate. Whilst it always has been a duty of the Board to have responsibility for internal controls, the need to make a compulsory statement by the Board confirming the adequacy of internal controls is new and has led to boards having to focus in particular on this area of responsibility. Many boards, in the past, did not pay enough attention to internal controls, often leaving it to internal audit to cover this aspect.

With the new SGX rules, boards and audit committees are struggling with what additional steps that they need to take with respect to internal controls so as to be able to give the required 1207(10) opinion.

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This article aims to set out details of some of the changes brought about by Rule 719(1) and give an idea of some of the actions that boards and audit committees should consider taking so as to be able to provide the required report under Rule 1207 (10).

The Changes

Rule 719 (1) states that, “An issuer should have a robust and effective system of internal controls, addressing financial, operational and compliance risks. The audit committee (or such other committee responsible) may commission an independent audit on internal controls for its assurance, or where it is not satisfied with the systems of internal control”.

In addition Rule 1207 (10) requires that the annual report includes an “Opinion of the board with the concurrence of the audit committee on the adequacy of the internal controls, addressing financial, operational and compliance risks”.

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What Are The Implications?

The board, before these changes introduced by SGX, did already have responsibility for the governance of risk, which includes internal controls. However, previously the requirement to comment on the adequacy and effectiveness of internal controls was part of the "Code of Corporate Governance", which is not mandatory, and may be departed from on a "comply and explain" basis.

The new SGX requirements require the board, with the concurrence of the audit committee, to give a formal mandatory written opinion on internal controls. Such an opinion cannot be given lightly. As with other opinions of this nature, the work carried out needs to be recorded properly. SGX has specifically stated that "The issuer should maintain proper documentation of the deliberations of the board and the audit committee".

Even for those entities with good internal controls, further work will need to be carried out by both the board and audit committee. In addition board members, who may have formerly paid scant attention to financial matters, will need to obtain a comprehensive understanding of internal controls and the procedures required to obtain comfort in this area.

The whole exercise will be more difficult for those entities with significant overseas operations as the Rule 1207 (10) report is for the Group, which would include the internal controls of the overseas entities.

What Are The Internal Controls That Need To Be Implemented?

Boards have often associated internal controls as just financial controls. However, SGX in its advisory note has made it clear that, "When providing this opinion, it is important that the board and the audit committee demonstrate that it has focused its attention in all 3 areas of risks, namely financial, operational and compliance when assessing the issuer's internal controls".

It is not the purpose of this paper to examine the technical aspects of internal controls but in general the three types of risks can be summarised as follows:

Financial Risks

Financial risks are associated with the financial structure and systems and the transactions a business makes. Identifying financial risk involves examining the daily financial operations, especially cash flow, recoverability of debts etc .

Financial risk assessment should also take into account external factors such as level of borrowings, interest rates and foreign exchange rates.

Operational Risks

Operational risks are associated with the business' operational and administrative procedures. These include:

- All aspects of the business
- staffing and management
- supply chain and transportation
- accounting controls
- IT systems
- regulations
- board composition

As can be seen from the list above the risks go far beyond what has been used as a base for the typical internal audit control reviews in the past.

Compliance Risk

Compliance risk is the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a business may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its business activities.

What Needs To Be Done By The Board And The Audit Committee

In general boards have previously delegated much of the work on internal controls and risks to the audit committee and/ or risk management committee. However, Rule 1207 (10) requires the board with the concurrence of the audit committee to report on the internal controls and not just the audit committee. This means ipso facto that all Board members must be conversant with what comprises internal controls and the procedures both necessary and carried out to obtain enough satisfaction to give the 1207 (10) report on internal controls.

There are a number of steps that the board/ audit committee will need to take to be able to obtain comfort on the adequacy and effectiveness of the internal controls. Some of these are set out below:

Ensure That The Internal Audit Function Is Adequate

Does the entity have an Internal Audit function and how robust is it? For the board to be able to give the required

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SGX report, it is highly unlikely that an entity without an internal audit function will be able to give an unqualified report on internal controls.

The internal audit arrangements may be internal or as an outsourced function. The board/ audit committee will need to assess the effectiveness of its internal audit procedures. In general, only the larger entities would be able to support a proper internalised internal audit department. A one man show rarely works and even worse he will often report to the CEO or be a part timer with other functions in the entity. For those who do not have an internalised audit function, there are a number of firms that you can engage to provide professional services in internal audit.

Unfortunately the typical internal audit process has only a partial role in obtaining comfort on the internal controls. Firstly internal audit tends to be focussed towards financial controls and not so much operational controls. The SGX report requires financial, operational and compliance risk to be covered. Secondly internal audit usually works on a cyclical basis covering key areas over a period of time. Between audits the controls in an area may lapse. The SGX report requires the report to be provided on all the areas at a particular point in time. Finally the internal audit will report on the various areas covered with exceptions being identified, but will not give an audit opinion on the Internal controls as a whole.

It is suggested that boards/ audit committees should extend the scope of work of their internal auditors to cover the key risks of the group, including operational risks, so as to give some assurance that they are being managed adequately. The ideal situation would be for the board to receive an assurance audit opinion from the internal auditors on the group's internal controls at the date that the entity is required to report. However as is explained later in this article, such a report is difficult, if not impossible, to obtain from the internal auditor.

Examine The Work Carried Out By Internal Audit

One of the roles of the audit committee, under the Code of Corporate Governance, is to review the adequacy and effectiveness of the company's internal audit function. Briefly this would include the review and approval of the audit plan, reviewing internal audit reports and following up on these reports to ensure that action has been taken. In addition the audit committee must discuss with the internal auditors, regularly, as the adequacy of internal controls in the group.

As regards the latter at least one meeting a year should be held without management. Sample questions that may be asked to the internal auditors can be found both in the "Guidebook for Audit Committees in Singapore" and the "Risk Governance Guidance for listed Boards". Both of which can be found on the web site of the Monetary Authority of Singapore.

Implement An "Enterprise Risk Management" System

In order to cover operational controls, in particular, it is likely that all listed entities need to implement a form of Enterprise Risk Management (ERM) system with and including an ERM risk matrix.

ERM is a process, put in place by an entity's board of directors, management and other personnel so as to identify potential events that may affect the entity and to manage them within its risk appetite.

ERM requires input from both management and the board. The end result will normally be a risk matrix. Management will provide inputs as to how best deal with the higher risks. In order to be effective, the board and management should regularly review the ERM risk matrix to take account of changing circumstances. It should not be considered as just a tick the box exercise but a dynamic assessment on an entities risks and how they are being and will be dealt with.

An ERM risk matrix is a good tool for the board as it enables the board to identify and focus on all operational risks and not just financial risks. Typically the risk matrix is colour coded with the highest risks being in red and the lowest in green. It is not intended to and does not replace the internal control framework, but rather incorporates the internal control framework within it, entities can use ERM to identify areas that internal audit needs to concentrate on.

There are many articles on ERM. The report "Risk Governance Guidelines for

Listed Boards" issued by the Corporate Governance Council on 10 May 2012 gives a summary of the ERM process in paragraph 6.

Consider Introducing A "Control Self Assessment"

In addition to having put in place ERM, boards, particularly for larger entities, should consider seriously the implementation of a "Control Self Assessment" (CSA). CSA is a process whereby management validates the operating effectiveness of its internal controls via testing. Typically the procedures would include:

- **Documentation of the control environment**
  Identifying the controls and document overall control environment.
- **Ascertain and evaluate risks**
  Identify the operational risks arising from the business and rate them.
- **Identify specific controls and test whether they are working**
  For each risk that is found, controls need to be identified and tested to ensure that they are working as intended. Where a control is found to be deficient, action would need to be taken to rectify the deficiency.
- **Monitoring and Reporting results**
  The results arising from CSA need to be periodically monitored to ensure that there are no breakdowns in controls. Regular reports of the results of testing and corrective action, where there are weaknesses, should be provided to senior management and the board.

There are various tools for CSA such as Flow Charts, Internal Control Questionnaires (ICOs), Control Guides, Workshops etc.

As is the case of ERM, CSA should not be considered a paper exercise but as a part of the process of managing risk. To this end the documentation should be regularly updated with regular reporting to the board/ audit committee.

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Discuss Internal Controls With The External Auditors

The Companies Act 201B (5)(a)(ii) includes as the function of an audit committee; "to review with the auditor, his evaluation of the system of internal accounting controls".

However, it should be noted that the external auditor only considers internal controls relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal controls.

In fact in some circumstances, the auditor may only place very limited reliance on controls for the purpose of the audit. In particular, where there are weak controls, other validation processes may be used to obtain the audit comfort.

Whilst the role of an external auditor concerning internal controls is technically limited, a responsible external auditor will include any identified weaknesses in the external auditor's management letter. The audit committee should review such letters and management's response and monitor the implementation of remedial action.

In addition to the management letter, in the one to one meeting between the audit committee and external auditor, which should be held at least annually, the audit committee should include questions on the robustness of internal controls in the entity and any weak areas that the external auditor may be aware.

Discussion With Management

Whilst the board is responsible for the governance of risk, it is up to management to maintain a sound system of risk management and internal controls to safeguard shareholders' interests and the company's assets.

In addition to the representation from management set out below, the board/ audit committee should discuss with management as to the design and operating effectiveness of the internal controls in the Group. Appendix B of the "Guidebook for Audit Committees in Singapore" gives details of typical questions that may need to be addressed to management.

Other Possible Areas Of Comfort

The areas mentioned above cover the normal avenues for obtaining comfort over internal controls. Boards need to be on the lookout for any other possibilities. For instance ISO certification may cover some of the operational risks, depending on the type of certification. The risk culture of the group will also play a significant part in determining the adequacy of internal controls. Risk culture is not a topic of this paper. However, it is important to note that if the board sets a high "tone at the top", the chances are that this will flow through to the lower levels of staff.

Representations And Reports

From Management

The board, pursuant to the Code of Corporate Governance, should comment in the company's annual report on whether it has received assurance from the CEO and the CFO … regarding the effectiveness of the company's risk management and internal control systems. This assurance should be obtained.

In addition to the above assurance, it is suggested that management give a similar report as to that required to be given by the board under A Rule 1207 (10), but adapted to reflect the responsibility of management. Having to provide this opinion on internal controls should focus the CEO and CFO on their responsibilities to implement adequate internal controls.

From Internal Auditor

Rule 719 (1) does state that "the audit committee (or such other committee responsible) may commission an independent audit on internal controls for its assurance". To be able to obtain a statement of assurance from the internal auditors that in their opinion the internal controls are adequate or a similar form of report, would give a high degree of comfort to the board. Unfortunately my attempts to get such an opinion from the major internal audit outsourcing firms has failed as presumably they do not want to take on the risks of giving such a report.

Under the circumstances the best that boards can do is for the internal auditor to carry out additional work on the key risks and report their findings.

Reports To Be Given Under Rule 1207(10)

SGX guidance on the form of reports states, "Where the board is satisfied that the issuer has a robust and effective system of internal controls, the disclosure would need to include the basis for such an opinion, which may include the scope of review by the board and the audit committee".

Acceptable Reports

The SGX has specified that the following two formats for reports are acceptable

Illustration 1

"Based on the internal controls established and maintained by the Group, work performed by the internal and external auditors, and reviews performed by management, various Board Committees and the Board, the Audit Committee and the Board are of the opinion that the Group's internal controls, addressing financial, operational and compliance risks, were adequate as at ………..".

Illustration 2

"The Board, with the concurrence of the Audit Committee, after carrying out a review, is of the opinion that the internal controls of the Group are adequate to address operational, financial and compliance risks. In arriving at the opinion, the Board is of the view that the internal controls of the Group have reasonable assurance about achieving the objectives set out below.

For the purpose of the Board expressing its opinion and in line with the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") Internal Controls Integrated Framework, "internal controls" is broadly defined as "a process effected by an entity's board of directors and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations".

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of assets. The second category relates to the preparation of reliable published financial statements, including interim and full year financial reports and financial information derived from such statements, reported publicly. The third category deals with complying with those laws and regulations to which the entity is subject.

Unacceptable Reports

The SGX has specified that the following as being unacceptable

Illustration 3 – Unacceptable

"The Board, with the concurrence of the Audit Committee, believes that there are adequate internal controls in the Company".

To avoid having the report rejected is suggested that boards follow one or other of the formats suggested by SGX and not to try and modify the report.

Qualified Reports Where Controls Are Inadequate

SGX has clarified that in circumstances that controls are inadequate, "Where the board and/or the audit committee is of the view that controls need to be strengthened or has concerns over any deficiency in controls, the board would have to disclose the areas of concerns and how it seeks to address and monitor the areas of concerns".

In general boards should take all steps to avoid a qualified report as it reflects badly on the entity and could result in questions being raised by SGX and the shareholders. Nevertheless, if there are areas of significant weaknesses in the internal controls these must be specified in the report as well as the steps to be taken to rectify the weaknesses.

Rider Paragraphs To The Report

Whilst it is necessary to follow the SGX format for the 1207 (10) report. It is acceptable to provide some clarifications, so long as they do not contradict the substance of the 1207 (10) report. Two examples of acceptable rider paragraphs are included below:

1. "The Board recognises that the internal control system provides reasonable but not absolute assurance to the integrity and reliability of the financial information and to safeguard the accountability of the assets

2. "The Board wishes to state that the system of internal controls provides reasonable, but not absolute, assurance as to financial, operational and compliance risks. No such system can provide absolute assurance against the occurrence of material errors and other situations not currently within the contemplation or beyond the control of the Board."

Location Of The Report

SGX's preference is to include the 1207 (10) report in the "Report of the Directors". This would seem to give more weight to the report as compared to including it as part of the "Corporate Governance" section, as the Directors' Report, includes statutory disclosures under the Company's Act and is specifically signed off by two Directors on behalf of the Board". The "Corporate Governance" section on the other hand is an attachment to the Annual Report and contains other general disclosures, including those under the "Code of Corporate Governance".

Some directors that I have spoken to maintain that the directors expose themselves to more personal liability by including the section 1207 (10) report in the "Directors' Report, but this would be up to lawyers to decide at the end of the day. Directors, no doubt should mitigate their own risks, so my suggestion is that the 1207 (10) report is included under the "Corporate Governance" section of the Annual Report. This would also seem the more appropriate place to include it as that is where many of the issues concerning governance and controls are set out.

Other Steps That Board Members Should Consider Taking

Readings

All Board members and not only those on the audit committee should read and become conversant with the "Guidebook for Audit Committees in Singapore", which can be accessed via the Monetary Authority of Singapore web site. There is much useful information both on internal controls and steps that need to be taken to get comfort in this area.

Another publication on the same web site, which is a must read for all boards, is the report "Risk Governance Guidance for Listed Boards" produced by the Corporate Governance Council.

There are also a number of articles that are available from the accounting firms and in professional magazines that are useful and should be read by directors wishing to obtain a better understanding on risks and internal controls.

Seminars

SID and other bodies run seminars covering many areas including internal controls. Seminars can be a useful way to not only obtain knowledge but to discuss with other directors as to how they are addressing issues. Rule 719 (1) has featured in a number of recent SID seminars.

Board Briefings

For those boards with members who are not conversant with accounting and internal controls, boards should consider running briefing sessions for their board members in this area. It should be noted that board briefings and seminars would count towards compliance with the Code of Corporate Governance guideline 1.6 and related disclosures in the Annual Report regarding training provided to new and existing directors.

Conclusion

Before the introduction of rule 719 (1), boards did have the responsibility for governance, which includes internal controls, but there was no requirement for the Board to produce a compulsory report as required by rule 1207 (10). In the past, internal controls tended not to be on the radar screens of boards as this area tended to be delegated to the audit committee. The SGX requirements now put internal controls as a key area of focus for listed entity boards. This is a positive move towards enhancing corporate governance.

Boards and Audit Committees should not give the 1207 (10) report lightly as it clearly puts the board in the hot seat. The new requirements are like a noose around the neck of board members. A corporate failure resulting from a slip up in the internal controls, accompanied by inadequate work in this area, and board members have the potential of being hauled up by the authorities or the courts or both. Boards that have carried out the necessary work on internal controls and have documented it properly should be able to mitigate their risks.

Whilst this article is not comprehensive it is hoped that it provides some thoughts as to what direction board members should look in order to be able to provide the 1207 (10) report.