

Practice Note 12B

Adequacy of Internal Controls

Cross-referenced from Rules 407(4)(b) and 1204(10)

1. Introduction

1.1 This Practice Note provides guidance on the application of Rules 407(4)(b) and 1204(10).

1.2 Issuers are required to disclose the following in their prospectuses and annual reports:

“Opinion of the Board with the concurrence of the audit committee on the adequacy of the internal controls, addressing financial, operational and compliance risks.”

Rule 407(4)(b) requires the disclosure to be made in the offer document whereas Rule 1204(10) requires the disclosure to be in the annual reports.

2. Intent of Rules 407(4)(b) and 1204(10)

2.1 Internal controls, including financial, operational and compliance controls, serve to safeguard shareholders' investments and company's assets.

2.2 The audit committee is usually responsible for overseeing internal controls. The Board, which includes executive directors, is also responsible for assessing the adequacy of these internal controls.

2.3 The objective of Rules 407(4)(b) and 1204(10) is to increase transparency and accountability. In providing this opinion, the Board and the audit committee are required to demonstrate that they have rigorously assessed the internal controls in relation to all three areas of risk, namely financial, operational and compliance.

3. Compliance with Rules 407(4)(b) and 1204(10)

3.1 In satisfying Rules 407(4)(b) and 1204(10), the Board and the audit committee may ask for an independent audit on internal controls to assure themselves on the adequacy of the controls, or if they are not satisfied with the systems of internal controls.

3.2 The issuer should maintain proper record of the discussions and decisions of the Board and the audit committee.

3.3 Compliance with Rules 407(4)(b) and 1204(10) involve the following disclosures:-

(i) Where the Board and the audit committee are satisfied that the issuer has a robust and effective system of internal controls, the disclosure must include the basis for such an opinion.

To avoid doubt, under Rule 225(1)(e), a full sponsor, in preparing a listing applicant for admission or advising an issuer in a very substantial acquisition or reverse takeover, must satisfy itself that the listing applicant or enlarged group has sufficient systems, procedures, controls and resources to comply with the Rules and that its directors understand and intend to fulfil their obligations at all times for as long as the securities of the issuer remain listed on Catalyst. This is in addition to Rule 407(4)(b) which requires the Board and audit committee to disclose their views on the robustness and effectiveness of the issuer's system of internal controls.

- (ii) In relation to Rule 1204(10), where the Board and/or the audit committee is of the view that controls need to be strengthened or has concerns that controls are inadequate, the Board would have to disclose the issues and how it seeks to address and monitor the areas of concerns.

4. Format of Disclosure

- 4.1 The provision of this opinion has no prescribed format.
- 4.2 As the Board and audit committee are obliged by Rules 407(4)(b) and 1204(10) to provide the specific disclosures in Paragraph 3.3 above, the Exchange recommends the opinion be provided in the following ways:-
 - (i) Disclosure to be made in the section on "Audit Committee" or "Internal Controls" of the offer document for compliance with Rule 407(4)(b).
 - (ii) Disclosure to be made in the Directors' Report or Corporate Governance section of the annual report for compliance with Rule 1204(10).

5. Illustrations on Compliance with Rules 407(4)(b) and 1204(10)

- 5.1 Good disclosures which comply with Rules 407(4)(b) and 1204(10) comprise the following:
 - (i) The Directors' opinion on the Group's internal controls addressing financial, operational and compliance risks; and
 - (ii) The basis for the Directors' opinion.
- 5.2 Should the Board with the concurrence of the audit committee disclose that in its opinion, the Group's internal controls has weaknesses, then clear disclosure of these weaknesses and the steps taken to address them is necessary for investors to make an informed decision about the Company.

Illustration of Good Disclosure - 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 [date].

(Comments:

1. *Factors that the Board and the Audit Committee considered and discussed in arriving at their opinion are stated.*
2. *Specific consideration was given to all 3 areas of risks - financial, operational and compliance.)*

Illustration of Good Disclosure - 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 provided reasonable assurance the objectives set out below would be achieved.

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:

- (a) effectiveness and efficiency of operations;
- (b) reliability of financial reporting; and
- (c) 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.

- 5.3 Positive and/or negative opinions from the Board including Audit Committee are acceptable as long as basis for the opinion has been disclosed. The Board should not provide generic statements which do not include the basis for the opinions.

Illustration of Poor Disclosure - Illustration 3

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

(Comments:

1. The rule requires an opinion from the Board with the concurrence of the Audit Committee. A statement that the Board, with the concurrence of the Audit Committee, believes that the internal controls are adequate is not acceptable.
2. The statement must make specific reference to financial, operational and compliance controls.
3. The disclosure must state the basis for the opinion or the scope of review by the Board and the Audit Committee.
4. The opinion required is in respect of the Group's and not the Company's internal controls.)