RECOMMENDED PRACTICE GUIDE

GUIDANCE FOR AUDITORS ON THE REVIEW OF DIRECTORS' STATEMENT ON INTERNAL CONTROL

Contents

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Foreword

The Council of the Malaysian Institute of Accountants has approved the issue of this Recommended Practice Guide (RPG) to members for guidance in undertaking engagements to review the directors' statement on internal control.

This Statement is jointly developed by the Malaysian Institute of Accountants and The Malaysian Association of Certified Public Accountants.

Introduction

1. The Kuala Lumpur Stock Exchange (KLSE) issued in January 2001 the revamped Listing Requirements as a move to further strengthen the capital market and securities industry in Malaysia. The stated key objectives of the revamp are:

   - To enhance corporate governance and transparency
   - To enhance efficiency in capital market activities
   - To strengthen investor protection and promote investor confidence

2. Under the revised KLSE Listing Requirements, listed issuers are required to include the following statements in the annual reports:

   - **Statement on Corporate Governance pursuant to paragraph 15.26 of the Listing Requirements**
   - **Statement on the State of Internal Control pursuant to paragraph 15.27(b) of the Listing Requirements**

   The Statement on the State of Internal Control (Statement on Internal Control or the Statement) is applicable for inclusion in annual reports containing audited financial statements for periods ending after December 31, 2001.

   Paragraph 15.24 of the KLSE Listing Requirements requires a listed issuer to ensure that the external auditors review the Statement made by the Board of Directors pursuant to paragraph 15.27(b) and report the results of the review to the board.

3. The purpose of this document is to provide guidance for auditors in reviewing the Directors' Statement on Internal Control.

Conflict of Interest

4. It is recognised that from time to time, situations giving rise to conflicts of interest may occur. Conflicts should, as far as possible, be avoided by not accepting any appointment or engagement in which conflict seems likely to occur.

5. The review of the Statement on Internal Control by the external auditor is an extension of the scope of the audit work performed with regard to the financial statements. No conflict of interest is considered to arise in the case where the external auditors who report on the financial statements, also undertake the review engagement for the Statement on Internal Control pursuant to paragraph 15.24 of the KLSE Listing Requirements.

Internal Control

Directors' responsibilities with respect to the Statement on Internal Control

6. Pursuant to paragraph 15.27(b) of the KLSE Listing Requirements, the Directors are required to include in the annual report "a statement about the state of internal control of the listed issuer as a Group". According to Practice Note 9/2001 issued by KLSE, the Directors are required to address in the Statement on Internal Control the following elements set out in the Malaysian Code on Corporate Governance (the Code):

   (a) Principle D II in Part 1 of the Code – The Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets

   (b) Best Practice AAI in Part 2 of the Code – The Board should explicitly assume the following specific responsibilities, which facilitate the discharge of the Directors' stewardship responsibilities:

   (Inter alia)
   - identifying principal risks and ensure the implementation of appropriate systems to manage these risks;
   - reviewing the adequacy and the integrity of the company's internal control systems and management information systems, including systems for compliance with applicable law*s*, regulations, rules, directives and guidelines.

   In making the Statement on Internal Control, the Directors should be guided by the "Statement on Internal Control: Guidance for Directors of Public Listed Companies" (ICG) which was issued by the Task Force on Internal Control in December 2000 with the support and endorsement of the KLSE. The Directors will be placed in a position to meet this reporting responsibility if the ICG is adequately followed. A review of internal control will likely encompass a review of the management information system.

7. In the section of the Statement on Internal Control dealing with how the Directors have applied Principle D II in Part 1 of the Code, the Directors should, as a minimum, disclose whether there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company that is regularly reviewed by the Directors. The ICG also states that the Directors may wish to provide additional information to assist understanding of the company's risk management processes and system of internal control. The content of such narrative statements is likely, therefore, to vary widely from company to company.

8. In relation to Best Practices Provision AA I in Part 2 of the Code, the Directors should disclose a summary of the process the Board (and where applicable, its committees) has applied in reviewing the adequacy and integrity of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report.

9. The Directors' Statement on Internal Control covers the year under review. If Directors become aware of events occurring between the period end and the date of approval of annual report, which materially affect the Statement on Internal Control, the Directors should consider whether such events are properly addressed and adequately disclosed in the Statement on Internal Control.

10. For parent companies, the review of the adequacy and integrity of the Group's internal control systems and the Statement on Internal Control included in the annual report should be from the perspective of the Group as a whole.

Auditors' responsibilities with respect to Directors' Statement on Internal Control

11. Pursuant to paragraph 15.24 of the KLSE Listing Requirements, auditors are required to review the Directors' Statement on Internal Control with regard to the state of internal control of the listed issuer and report the results thereof to the Board of Directors of the listed issuer.

12. The objective of the auditors' review is to assess whether the Statement on Internal Control appropriately reflects that process the Directors (and where applicable its committees) have adopted in reviewing the adequacy and integrity of the system of internal control.

13. To achieve this objective, appropriate evidence will usually be obtained by performing the following procedures:

    (a) enquire of the Directors to obtain an understanding of the process defined by the Board of Directors for their review of the adequacy and integrity of internal control and compare their understanding to the Statement intended to be made by the Directors in the annual report;

    (b) review the documentation prepared by or for the Directors to support their Statement intended to be made in connection with Principle D II in Part 1 of the Code;

    (c) relate the Statement intended to be made by the Directors to the auditors' knowledge of the Company/Group obtained during the audit of the financial statements. As explained in paragraph 15, the scope of the Directors' review will likely be broader than the knowledge the auditors can be expected to have based on their audit of the financial statements.

    (d) review the minutes of the meetings of the Board of Directors, and of relevant Board committees (for example audit, management information system and risk committees)

(e) attend meetings of the audit committee at which the annual report, including the Statement on Internal Control is considered and approved for submission to the Board of Directors.

14. The auditors should consider whether the Directors' Statement on Internal Control covers the year under review and that adequate processes are in place to identify any significant matters arising. Where any such matter has been identified, the auditors should consider the matter and the implications on the Directors' Statement on Internal Control to the date of the approval of the annual report.

15. In carrying out their review, the auditors should have regard to the knowledge of the company they have obtained from their audit work. To enable them to perform their audit and express an opinion on the financial statements, auditors are required by applicable approved auditing standards in Malaysia to understand the company's control environment and to assess the components of audit risk. Such an assessment encompasses control risk to the extent that the auditors expect to be able to rely on such an assessment in order to reduce the extent of their substantive audit procedures. The auditor's assessment required by approved auditing standards in the context of the audit objectives applicable for the financial statements will likely be narrower in scope than the review performed by the Directors for the purpose of reporting in compliance with Principle D II in Part 1 of the Code.

16. The auditors should obtain written representations from Directors on matters material to the Statement on Internal Control when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

If a representation by Directors is contradicted by other audit evidence, the auditors should consider the circumstances and, when necessary, reconsider the reliability of other representations made by Directors. The auditors should also be guided by paragraphs 27 to 29 of this document where applicable, in these circumstances.

17. Auditors are not expected to assess whether all risks and controls have been addressed by the Directors or that risks are satisfactorily addressed by internal controls. In order to communicate this fact to the Board of Directors, the following sentence is included in the auditors' report to the Board on their review of the Statement. (see Appendix 3).

"We are not required to consider whether the Directors' Statement on Internal Control covers all risks and controls, or to form an opinion on the effectiveness of the Group's risks and control procedures."

18. In view of the obligations placed on Directors by the ICG, the Councils of the Malaysian Institute of Accountants (MIA) and The Malaysian Association of Certified Public Accountants (MACPA) recommend that any material weaknesses in internal control identified by the auditors in the course of their audit be reported to Management, the Audit Committee or the Board, as considered appropriate, as soon as is practicable. The auditors should not wait until the audit of the financial statements has been completed before reporting such material weaknesses. In this manner, the Directors will be afforded an opportunity to be aware of the weaknesses that the auditors have identified and be able to consider appropriate responses as well as to take account of them in making their Statement on Internal Control. This is consistent with International Standards on Auditing (ISA) 400, *Risks Assessments and Internal Control*, paragraph 49 which states:

"The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention."

Internal control aspects of problems disclosed in the annual report

19. The ICG also requires the Board of Directors to disclose 'the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report'.

20. This may be a difficult requirement for Directors to satisfy, and for auditors to review, because what is meant by 'significant problems' is not defined and the word 'problem' encompasses more than financial matters. For example, a description of difficulties obtaining raw materials at a remote overseas location may be seen as a significant problem by directors of some companies but not the directors of others.

    Even when the Directors have identified a problem it may not always be clear whether the problem has material internal control aspects. A significant loss making contract, for example, may be attributable to changes in circumstances that could not reasonably have been foreseen, rather than to weaknesses in internal control.

21. To address the above, the auditors:

    (a) discuss with the Directors the steps the Directors have taken to determine what significant problems are disclosed in the annual report; and

    (b) assess whether disclosures made by the Directors of the processes they have applied to deal with material internal control aspects of any significant problems disclosed in the annual report appropriately reflect those processes.

22. The auditors are not required to assess whether the processes described by the Directors will, in fact, remedy the problem described in the annual report. The following sentence is therefore included in the auditors' report to the Board on their review of the Statement (see Appendix 3).

    "We are not required to consider whether the processes described to deal with material internal control aspects of any significant problems disclosed in the annual report will, in fact, remedy the problems."

23. If the auditors are aware of a significant problem that is disclosed in the annual report for which the Directors have not disclosed the material internal control aspects, the auditors should discuss the position with the Directors of the company. If the auditors are not able to agree with the Directors as to how the matter should be resolved, the auditors should consider the guidance provided in paragraphs 27 to 29 of this document.

Failure to conduct a review

24. Paragraph 44 of the ICG states that**:**

    "Where a Board cannot make one or more of the disclosures in paragraphs 40, 41 and 42, it should state this fact and provide an explanation. The KLSE Listing Requirements

require the Board to disclose if it has failed to conduct a review of adequacy and integrity of the company's systems of internal controls."

The auditors should consider whether this requirement is met and whether the explanation is consistent with the auditors' understanding.

(See Appendix 2 for extracts of the paragraphs of the ICG referred to above)

Groups of companies

25. According to paragraph 46 (see Appendix 2) of the ICG, where material joint ventures and associated companies have not been dealt with as part of the group for the purposes of applying the ICG, this fact should be disclosed. The auditors should assess, based on their knowledge of the group obtained during the audit of the financial statements, whether any material joint ventures or associated companies have not been dealt with and, therefore, if such a disclosure is necessary.

Report to the Board of Directors

26. The auditors' report to the Board of Directors on its Statement on Internal Control should contain a clear written expression of negative assurance. The auditors should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance. An example of the auditors' report is included in Appendix 3.

27. The auditors should report the following circumstances to the Board of Directors with a view to seek revision of their draft statement, if they conclude:

    (a) that the Directors' summary of the process they have applied in reviewing the adequacy and integrity of internal control is either not supported by or does not appropriately reflect the auditors' understanding of the process undertaken;

    (b) that the processes disclosed to deal with material internal control aspects of significant problems disclosed in the annual report do not appropriately reflect the auditors' understanding of the process undertaken;

    (c) that no disclosure has been made by the Directors that they have failed to conduct a review of the adequacy and integrity of the system of internal control;

    (d) where the Directors disclosed that they have not reviewed the adequacy and integrity of the system of internal control, that their explanations are not consistent with the auditors' understanding; or

    (e) that no disclosure has been made by the Directors that a material joint venture or associated company has not been dealt with as part of the Group.

    If revisions sought are not accepted by the Board of Directors, the auditors should consider the guidance in paragraphs 28 and 29 of this document.

Report to members

28. The auditors are not expected to actively search for misstatements or inconsistencies. However, if the auditors become aware of such a matter, the auditors should discuss it

with the Directors to seek to establish the significance of the lack of proper disclosure. If such lack of proper disclosure is considered significant by the auditors and the Directors cannot be persuaded to amend the disclosure to the auditors' satisfaction, the auditors should consider the implications on the auditors' reporting responsibilities and may need to take legal advice.

29. If, after reviewing the Statement on Internal Control, the auditors identify a material inconsistency, the auditor*s* should determine whether the financial statements or Statement on Internal Control need to be amended.

(a) If an amendment is necessary in the financial statements and the Directors refuse to make the amendment, the auditor*s* should express qualified or adverse opinion.

(b) If an amendment referred to in paragraph 27 is necessary in the Statement on Internal Control but not the financial statements, and the Directors refuse to make the necessary amendment, the auditor*s* should consider taking further appropriate action, including disclosure in the auditors' report to members. However, as this does not give rise to a qualified audit opinion on the financial statements it is recommended that the auditors' comments be included under the heading *"*Other matter*s*" as illustrated below.

"Other matter*s*

In accordance with paragraph 15.24 of the KLSE Listing Requirements, we have reviewed the Directors' Statement on Internal Control set out on page x of the annual report. In our opinion the Directors' comments concerning... do not appropriately reflect our understanding of the process undertaken by the Board because ... Our opinion on the financial statements is not qualified in this respect."

Appendix 1

Extracts of Relevant KLSE Listing Requirements

Requirements of Auditors

15.24 Review of Statements

A listed issuer must ensure that the external auditors review a statement made by the board of Directors of a listed issuer pursuant to subparagraph 15.27(b) below, with regard to the state of internal control of the listed issuer and report the results thereof to the board of Directors of the listed issuer.

Statement of Directors' Responsibilities on Audited Accounts and Internal Control

15.27 Additional statements by the Board of Directors

A listed issuer must ensure that its Board of Directors makes the following additional statements in its annual report:-

(a) a statement explaining the Board of Directors responsibility for preparing the annual audited accounts; and

(b) a statement about the state of internal control of the listed issuer as a Group.

Appendix 2

Extracts of Statement on Internal Control – Guidance for Directors of Public Listed Companies

The Board's Statement on Internal Control

39. Paragraph 15.27 (b) of the KLSE Listing Requirements states that a listed issuer must ensure that its board of directors includes in its annual report "a statement about the state of internal control of the listed issuer as a group". The board will be placed in a position to meet this reporting responsibility if the guidance in the preceding sections is adequately followed.

40. In its Statement of how the company has applied Principle D II in Part I of the Code, the board should, as a minimum, disclose whether that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, whether it has been in place for the year under review, whether it is regularly reviewed by the board and whether it accords with the guidance in this document.

41. In relation to Best Practice Provision AA I in Part 2 of the Code, the board should summarise the process it (where applicable, through its committees) has applied in reviewing its adequacy and the integrity of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report.

42. The disclosures relating to the application of Principle D II in Part I of the Code should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its adequacy and integrity. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

43. The board may wish to provide additional information in the annual report to assist understanding of the company's risk management processes and system of internal control.

44. Where a board cannot make one or more of the disclosures in paragraphs 40, 41 and 42 it should state this fact and provide an explanation. The Listing Requirements require the board to disclose if it has failed to conduct a review of the adequacy and the integrity of the company's system of internal control.

45. The board should ensure that its disclosures provide meaningful, high-level information and do not give a misleading impression.

46. Where material joint ventures and associated companies have not been dealt with as part of the group for purposes of applying this guidance, this should be disclosed.

Appendix 3

Example of Auditors' Review Report to Board of Directors

REPORT OF AUDITORS TO BOARD OF DIRECTORS OF…….…..
ON ITS STATEMENT ON INTERNAL CONTROL

We have reviewed the Directors' Statement on Internal Control intended to be included in the annual report for [year]. This statement is the responsibility of the Directors. Our responsibility is to issue a report to the Board on the Directors' Statement on Internal Control based on our review.

We conducted our review in accordance with the Terms of Engagement dated ……. and Recommended Practice Guide 5, *Guidance for Auditors on the Review of Directors' Statement on Internal Control* (RPG 5). Our review has been conducted to assess whether the Statement on Internal Control is both supported by the documentation prepared by or for the Directors and appropriately reflects the process the Directors have adopted in reviewing the adequacy and integrity of the system of internal control for the Group.

RPG 5 does not require us to consider whether the Directors' Statement on Internal Control covers all risks and controls, or to form an opinion on the effectiveness of the Group's risk and control procedures. RPG 5 also does not require us to consider whether the processes described to deal with material internal control aspects of any significant problems disclosed in the annual report will, in fact, remedy the problems.
.
Based on our review, nothing has come to our attention that causes us to believe that the Statement on Internal Control intended to be included in the annual report is inconsistent with our understanding of the process the Board Directors has adopted in the review of the adequacy and integrity of internal control of the Group.

(Audit firm)
Kuala Lumpur
(Date)

Appendix 4

Example Terms of Engagement

The following is an illustrative example of paragraphs that may be included in the auditor's engagement letter dealing with their responsibilities with respect to the Directors' Statement on Internal Control as required by the KLSE Listing Requirements.

To the Board of Directors

We are writing to confirm our additional responsibilities as auditors in relation to the Statement on the State of Internal Control (Statement on Internal Control) required to be provided by the Board pursuant to the Kuala Lumpur Stock Exchange (KLSE) Listing Requirements. This engagement letter is in addition to our existing audit engagement arrangements set out in our letter of [date].

Responsibilities of Directors

As Directors of the Company, you are responsible for ensuring that the Company complies with the KLSE Listing Requirements including paragraph 15.27(b) in relation to the Directors' Statement on Internal Control. In preparing the Statement on Internal Control, the Directors should be guided by the Statement on Internal Control – Guidance for Directors of Public Listed Companies (ICG).

Whilst the Statement is required to be in respect of the financial period covered by the financial statements included in the annual report, if the Board becomes aware of events occurring between the period end and the date of approval of annual report, which materially affect the Statement on Internal Control, the Board should consider whether such events are properly addressed and adequately disclosed in the Statement on Internal Control.

Responsibility of Auditors

Paragraph 15.24 of the KLSE Listing Requirements states that the Company must ensure that the external auditors review the Directors' Statement on Internal Control and report the results thereof to the Board of Directors of the Company.

Accordingly, we will carry out the review of the Directors' Statement on Internal Control having regard to the guidance published in RPG 5, *Guidance for Auditors on the Review of Directors' Statement on Internal Control*.

We are not required to form an opinion on the Directors' Statement on Internal Control.

Scope of Review on Statement on Internal Control

We shall request sight of all documentation prepared by or for the Board in support of the Directors' Statement on Internal Control. You will provide us with such information and explanations as we consider necessary. We may request you to provide written confirmation of oral representations which you make to us during the course of our reviews.

As we have agreed, we will attend the meeting of the audit committee at which the annual report, including the Statement on Internal Control, is considered and approved for submission to the Board of Directors.

With respect to paragraph 15.24 of the KLSE Listing Requirements, our work will be restricted to:

- assessing, based on enquiry of the Directors, the supporting documentation prepared by or for the Directors and our knowledge obtained during the audit of the financial statements, whether the Company's summary of the process the Board (and where applicable its committees) has adopted in reviewing the adequacy and integrity of internal control appropriately reflects that process;

- assessing whether the Company's disclosures of the processes it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report appropriately reflect those processes;

- ensuring that disclosure is made if no review of the adequacy and integrity of internal control has been conducted, and that explanations in relation thereto are consistent with our understanding; and

- ensuring that disclosure is made in the Statement where a material joint venture or associated company has not been dealt with as part of the Group for the purposes of the Statement.

As our work is not designed to consider whether the Directors' Statement on Internal Control covers all risks and controls, or to form an opinion on the effectiveness of the Company/Group's risk and control procedures, our review of the Statement on Internal Control will not be designed to enable us to express any assurance as to whether or not your internal controls are effective. In addition, our audit of the financial statements should not be relied upon to draw to your attention to matters that may be relevant to your consideration as to whether or not your system of internal control is effective.

If, after reviewing the Directors' Statement on Internal Control, we identify a material inconsistency in the Statement and the circumstances are such that in our opinion, the matter has not been adequately addressed by the Directors, RPG 5 requires us to consider taking further appropriate action, including disclosure in our audit report to the members of the Company.

Fees

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

Agreement of terms

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of engagement.
.
We look forward to full cooperation with your staff and we trust that they will make available to us the relevant records, documentation and other information requested in connection with our review.

(Audit firm)
Acknowledged on behalf of
ABC Company by

(signed)
……..

Name and Title
Date

Abbreviations used

References used in this technical release are as follows:

Code	The Malaysian Code on Corporate Governance

ICG	Statement on Internal Control – Guidance for Directors of Public Listed Companies, issued by the Taskforce on Internal Controls
ISA	International Standards on Auditing
KLSE	Kuala Lumpur Stock Exchange