 <b>HONG KONG MONETARY AUTHORITY</b> 香港金融管理局		
<b>Supervisory Policy Manual</b>		
<b>IC-3</b>	<b>Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance</b>	Consultation

This module should be read in conjunction with the [Introduction](#) and with the [Glossary](#), which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

### **Purpose**

To provide guidance in respect of the reporting obligations of Als' external auditors under the Banking Ordinance

### **Classification**

A non-statutory guideline issued by the MA as a guidance note

### **Previous guidelines superseded**

Guideline 9.1 "Banking Ordinance: Auditors and Reporting under Section 61 to the Commissioner of Banking" dated 31.12.90; Guideline 9.2 "Auditors' Certificates on Statistical Returns" dated 23.07.91; and Guideline 9.3 "Internal Control Systems" dated 15.08.92

### **Application**

To all Als (parts applicable only to locally incorporated Als are stated as such)

### **Structure**

1. Introduction
  - 1.1 Background
  - 1.2 Role of the auditors
  - 1.3 Legal framework



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2. Appointment, removal and resignation of auditors
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    - 6.1 Protection
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  - B: Controls relating to compliance with statutory provisions in the Banking Ordinance
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# 1. Introduction

## 1.1 Background

1.1.1 External auditors (hereinafter referred to as “the auditors”) play an important role in the supervisory process. In addition to conducting audits of AIs, there are provisions in the Banking Ordinance requiring them to prepare various reports used in the supervisory process and inform the MA of certain specified matters in relation to an AI.

1.1.2 The Basel Committee on Banking Supervision recognises the importance of the use of auditors in its Core Principles for Effective Banking Supervision. Principles 19 and 21 relate to the use of auditors to:

- help ensure that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices. This enables the supervisors to obtain a true and fair view of the banks' financial condition and profitability; and
- perform independent checking to ensure the validity of the supervisory information.

## 1.2 Role of the auditors

1.2.1 The key responsibility of a bank's auditors is to express an opinion as to whether the bank's financial statements give a true and fair view and have been prepared in accordance with generally accepted accounting principles. The auditors are required to conduct the audit in accordance with applicable ~~ethical and auditing standards~~[Statements of Auditing Standards issued by the Hong Kong Society of Accountants \(HKSA\)](#), including ~~those calling for independence, objectivity, professional competence, due~~



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~~care and~~ adequate planning and supervision. The auditors are also required to observe the ethical standards promulgated by the HKSA, including those calling for independence, objectivity, professional competence and due care.

1.2.2 Apart from this responsibility, the auditors may communicate with those charged with governance of the bank ~~provide recommendations~~ (e.g. through a management letter) ~~to the bank for the purpose of rectifying material~~ weaknesses identified in its internal control system during the course of the audit ~~and provide recommendations for improvement.~~

1.2.3 The auditors may also be required to report on certain specified events or make regular reports to the supervisors in addition to the audit report on the bank's financial statements.

### 1.3 Legal framework

1.3.1 Companies incorporated under the Companies Ordinance (including locally incorporated AIs) are required to appoint auditors at each annual general meeting of the company. Pursuant to §141 of the Companies Ordinance, the auditors are required to examine the accounts of the company and to report to the shareholders of the company on whether, in their opinion, the accounts give a true and fair view of the company's financial position and have been prepared in accordance with the provisions of the Companies Ordinance.

1.3.2 Under §59(1) of the Banking Ordinance, every AI and its auditors<sup>1</sup> should comply with the Companies Ordinance with respect to the audit of a company's accounts, whether or

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<sup>1</sup> Under §2 of the Banking Ordinance, an "auditor" means a professional accountant holding a practising certificate under the Professional Accountants Ordinance.



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not the AI is incorporated under that Ordinance<sup>2</sup>. Locally incorporated AIs should submit their [audited accounts annual report](#) (including a set of [audited](#) annual accounts, an auditors' report and a directors' report) to the MA within four months after the close of each financial year (for overseas incorporated AIs the time limit is six months).

1.3.3 Set out below is a summary of the auditors' major duties and responsibilities in relation to prudential supervision under the Banking Ordinance:

- **Reporting on statistical returns**
  - Pursuant to §63(3) of the Banking Ordinance, AIs are required to appoint auditors to report, normally once a year, on whether a [statistical](#) return or information submitted by them is correctly compiled, in all material respects, from their books and records and, if not, the nature and extent of the incorrectness (see section 3 below).
  - Under §50(1)(c) of the Banking Ordinance, locally incorporated AIs which maintain an overseas branch may need to appoint auditors, if the MA so requires, to report on whether a return or information submitted by them in respect of their overseas branch(es) is correctly compiled, in all material respects, from the books and records of the branch(es).
- **Reporting on systems of control over the compilation of returns**

§63(3A) of the Banking Ordinance requires AIs to appoint auditors to report, normally once a year, on

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<sup>2</sup> Under §60(6) of the Banking Ordinance, the MA may by notice in writing exempt an AI to comply with §59(1). Normally this exemption will be granted on an annual basis and only to overseas incorporated AIs.



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the adequacy of their systems of control over the compilation of statistical returns or other information, compliance with certain statutory provisions in the Ordinance and ~~the~~ locally incorporated AIs' maintenance of adequate provisions (see subsection 4.2 below).

- **Reporting on specific systems of control**

Under §59(2) of the Banking Ordinance, AIs may be required to appoint the auditors, normally on a needs basis, to report on (see subsection 4.3 below):

- their state of affairs or profit and loss or both; or
- the adequacy of specific systems of control.

- **Reporting of qualification or adverse statement**

Under §59A(2)(c) of the Banking Ordinance, AIs' auditors appointed under §131 of the Companies Ordinance are required to provide a written notice to the MA if they decide to include in their report on an AI's accounts any qualification or adverse statement as to a matter mentioned in §141 of the Companies Ordinance.

- **Reporting of significant adverse matters and non-compliance cases**

§§63A and 63B of the Banking Ordinance require AIs' auditors to submit a report to the MA if, in the course of performing their duties as auditors, they become aware of any matter ~~in the course of performing their duties as auditors~~ that in their opinion:

- adversely affects an AI's financial position to a material extent (see subsection 5.1 below); or



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- constitutes on the part of a registered AI<sup>3</sup> a failure to comply with certain provisions or rules made under the Securities and Futures Ordinance ("SFO") (see subsection 5.2 below).

1.3.4 To facilitate a direct dialogue between AIs' auditors and the MA, there are protection clauses in the Banking Ordinance:

- §61 of the Banking Ordinance protects the auditors, despite any duty which they may owe to their clients (e.g. confidentiality), where they communicate to the MA in good faith any information or opinion on a matter of which they become aware in their capacity as auditors and which is relevant to any function of the MA under the Ordinance (see subsection 6.1 below); and
- §120(5)(g) of the Banking Ordinance allows the disclosure of information by the MA to the auditors of an AI or former AI, or to the former auditors, for the purpose of enabling or assisting the MA to discharge his functions under the Ordinance (see subsection 6.3 below).

## 2. Appointment, removal and resignation of auditors

### 2.1 Appointment

2.1.1 Reports under §§50(1)(c), 59(2), 63(3) and 63(3A) should be submitted by a firm of auditors appointed by an AI and approved by the MA. The auditors so appointed should be:

- the auditors appointed by the AI prior to the report being so required and approved by the MA for the purpose of preparing the report; or

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<sup>3</sup> A "registered AI" means an AI that is a registered institution under the SFO.



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- the auditors approved or nominated by the MA for the purpose of preparing the report after consultation with the AI.
- 2.1.2 The auditors referred to under §§63A and 63B of the Banking Ordinance (see section 5 below) are persons appointed:
- by shareholders of a locally incorporated AI, under §131 of the Companies Ordinance, to report on whether the AI's accounts show a true and fair view and have been properly drawn up in accordance with the provisions of that Ordinance; or
  - by the AI to submit a report to the MA under §§59(2), 63(3) or 63(3A) of the Banking Ordinance.
- 2.1.3 Accordingly the auditors for the various purposes under the Banking Ordinance (except §59(2) - see para. 2.1.4 below) will normally be an AI's existing auditors. The MA reserves the right, however, to commission reports from another firm of auditors where:
- he considers that this arrangement can better utilise the knowledge and expertise of different auditors which may be beneficial to the AI; or
  - he has reason to believe that the existing auditors would not be capable of producing an adequate report. In reaching this judgement, he will take into account:
    - the reputation of the existing auditors;
    - the quality of the reports previously submitted to him;
    - the expertise, knowledge and resources of the existing auditors; and
    - any potential conflict of interest on the part of the existing auditors.





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- 2.1.4 Even where there are no doubts about the capability of the existing auditors, the MA may require that a report under §59(2) of the Banking Ordinance should be obtained from another firm of auditors. This would be to obtain a fresh and independent perspective on the matters which are the subject of the review.
- 2.1.5 If the MA is not intending to approve the existing auditors, he will first consult the AI concerned and request it to propose another firm of auditors for his approval. If the AI fails to propose a satisfactory firm within a specified timeframe, he will nominate a selection of suitable firms from which the AI will be required to choose.
- 2.1.6 An audit firm may be appointed by AIs to carry out a variety of assignments and these may be carried out by different departments of the audit firm. Auditors may therefore wish to consider whether reporting lines should be established within the firm so as to enable any important matters concerning clients to be brought to the attention of the auditors in the firm responsible for the annual audit or any review performed under the Banking Ordinance.
- 2.1.7 Where an AI appoints a third party (i.e. other than the existing auditors) to review any matters relating to its assets, internal controls and accounting records, the MA would expect the AI to inform its auditors of such an appointment. The AI should also make available to its auditors without delay the reports of any such reviews.

[In the case of an overseas incorporated AIs, this requirement applies to the review of the AI's business in Hong Kong.](#)

## 2.2 Removal

- 2.2.1 §59A(1) of the Banking Ordinance requires a locally incorporated AI to notify the MA if:



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- the AI proposes to give notice to its members of an ordinary resolution removing its auditors before the expiration of the term of office;
- the AI gives notice to its members of an ordinary resolution replacing its auditors at the expiration of the term of office; or
- a person ceases to be an auditor of the AI otherwise than in consequence of such a resolution.

### 2.3 Resignation

2.3.1 Under §59A(2) of the Banking Ordinance, an AI's auditors appointed under §131 of the Companies Ordinance should provide a written notice to the MA if they:

- resign before the expiration of the term of office; or
- do not seek to be re-appointed.

## 3. Auditors' certificates on statistical returns

### 3.1 Purpose and coverage

3.1.1 The HKMA monitors AIs' financial condition and profitability through data collected via statistical returns and other means on a regular basis.

3.1.2 The arrangements whereby the auditors report on statistical returns under §63(3) of the Banking Ordinance are intended to check, on a sample basis, the accuracy and reliability of the data submitted by AIs in the returns.

3.1.3 Under §63(3) of the Banking Ordinance an AI will normally be required by the MA to commission a report from its auditors each year on whether certain returns or information submitted to the MA have been correctly compiled in all material respects from its books and records. Normally the



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scope of the §63(3) report does not cover surveys (e.g. on credit card lending and residential mortgage lending).

3.1.4 The returns to be reviewed will normally be:

- for locally incorporated AIs:
  - Capital adequacy (all parts);
  - Large exposures (~~pages 2 – 4~~[Parts I and II](#), columns 1 - 5)<sup>4</sup>;
  - Liquidity (Part I); and
  - Compliance (Parts I - III).
- for overseas incorporated AIs:
  - Large exposures (~~pages 2 – 4~~[Parts I and II](#), columns 1 - 5)<sup>4</sup>;
  - Liquidity (Part I); and
  - Compliance.

However, the MA reserves the right to require a report on other returns or information submitted under §§50(1)(a) & (b) and 63(1) & (2).

3.1.5 The returns to be checked should be the most comprehensive in the series. Thus where an AI completes a consolidated return it should be that return which is checked. Where it has overseas branches but no subsidiaries the combined return should be checked, and so on. The returns only apply, in the case of overseas incorporated AIs, to their Hong Kong offices.

## 3.2 Reporting frequency and timing

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<sup>4</sup> [Effective from end-March 2004, the parts of Large Exposures Return subject to review will be Parts I, II and III, columns 1-5 for both locally and overseas incorporated AIs.](#)




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- 3.2.1 The returns are normally to be checked annually. The frequency may, however, be increased if there are particular grounds for concern.
- 3.2.2 The returns to be checked should all relate to one date or period. Normally returns with a common reporting date will be chosen for review on a random basis, i.e. as at end-March, end-June, end-September or end-December. The date or period will not necessarily be coterminous with the end of an AI' s financial year.
- 3.2.3 The particular reporting date will be chosen retrospectively and notified in writing to the AI concerned shortly after the returns have been submitted. This notification letter will be copied to the auditors directly. AIs should therefore retain the necessary information, including the working papers, for a sufficient time to ensure that this work can be done.
- 3.2.4 Notwithstanding the foregoing, the MA reserves the right to add other reporting dates into the process if he is not satisfied with the quality of an AI's data compiled.
- 3.2.5 The auditors' report should be submitted by the AI to the MA, with any comment the AI wishes to make, not later than two months from the date of the MA' s notification letter.

### 3.3 Criteria for reporting errors

- 3.3.1 The MA requires only errors which are material in amount or indicative of weaknesses in the compilation process to be drawn to his attention. The intention is for the auditors to focus on the quality of the statistics provided rather than on identifying minor reporting errors. What constitutes material will need to be judged by the auditors on a case-by-case basis. For example, an error should normally be considered material if it exceeds 5% of the applicable item in the return to which it relates.
- 3.3.2 Auditors should prepare the report based on the findings identified in the returns originally submitted to the MA unless

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the MA specifies otherwise. Any subsequent amendments to the returns to correct the reporting errors identified [after the submission or](#) during the course of the review should not be considered.

- 3.3.3 AIs and their auditors should bear in mind the provisions of §§50(6) and 63(7) of the Banking Ordinance relating to the knowing or reckless provision of false or misleading information.

## **4. Auditors' reporting on various internal control systems**

### **4.1 General**

4.1.1 The Banking Ordinance splits the reporting requirement on internal controls into two broad categories:

- AIs are required to submit reports by auditors on certain internal control systems on a recurring annual basis; and
- reports on other internal control systems are to be commissioned on an ad hoc basis as needed.

### **4.2 Annual reviews**

4.2.1 The MA is empowered under §63(3A)(a) of the Banking Ordinance to require an AI to submit an auditors' report on whether, during a specified period, the internal control systems of the AI were such as to enable, as far as practicable:

- the correct compilation of returns or information from the books and records of the AI (see Annex A);
- compliance by the AI with the provisions under Parts XII, XV, XVII and XVIII of the Ordinance (see Annex B); and



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- in the case of locally incorporated AIs, adequate provision for depreciation or diminution in the value of assets (including provision for bad and doubtful debts) and for actual or potential liabilities and losses (see Annex C).
- 4.2.2 Having completed this work, the auditors should also report under §63(3A)(b) of the Banking Ordinance in respect of the same period on:
- any material contravention of the provisions under Parts XII, XV, XVII and XVIII<sup>5</sup> of the Ordinance by the AI; and
  - in the case of locally incorporated AIs, any failure to maintain adequate provisions.
- 4.2.3 Only one report is to be submitted under §63(3A) and it will normally be required annually.
- 4.2.4 The report submitted under §63(3A) should cover all the matters set out in paras. 4.2.1 and 4.2.2 above. A report will not be required on a matter referred to in §63(3A)(b) unless the requirement also relates to a matter referred to in §63(3A)(a). Thus a report under §63(3A)(b) will not be commissioned in isolation.
- 4.2.5 In reporting under §63(3A)(b), the auditors will draw particularly on their work performed under §63(3A)(a) but they will also be expected to take into account any other relevant information<sup>6</sup> which comes to their attention in their capacity as auditors of the AI, including in the normal course of their audit work and in their review of returns under §63(3). They will not, however, be expected to change the

<sup>5</sup> [Part XVIII of the Ordinance does not apply to overseas incorporated AIs.](#)

<sup>6</sup> It is recognised that such information may already have given rise during the period under review to a report under §§61, 63A and 63B. In such cases the auditors will not be required to report again on the matter under §63(3A)(b) unless there had been further developments which materially affected the position.



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scope of their audit work nor the frequency or timing of their audit visits. In cases where the audit work has not been completed, the auditors can refer to that fact in their report.

- 4.2.6 For overseas incorporated AIs which are exempt from local statutory audits, the auditors are expected to set the scope and extent of tests to facilitate their reporting in accordance with the requirements of §63(3A)(a) and (b).
- 4.2.7 The period to be covered by a report under §63(3A) will not normally be more than 12 months unless the MA is satisfied that a longer period is required in the interest of the depositors or the public. Usually it will be the financial year of the AI so as to coincide with the work on the annual audit. In the case of an overseas incorporated AI, a different period for review may be agreed if that is mutually convenient to the AI, its auditors and the MA. Once determined for the initial report, the review period will normally be the same for subsequent reports.
- 4.2.8 The scope and period to be covered by the report required under §63(3A) will normally be notified in writing to AIs three months before the end of the period to be reviewed. The notification letter will be copied to the auditors directly. The AI should in turn issue a letter of instruction to its auditors with a copy to the MA. [The letter of instruction can remain effective from one accounting period to another, until it is replaced.](#)
- 4.2.9 The report should be submitted to the AI by the auditors not later than three months from the end of the review period and should be forwarded to the MA with the comments of the AI, if any, within a further month.
- 4.2.10 In making a report on internal controls under §63(3A)(a), the auditors will be asked to report on both the existence of controls and whether they have operated effectively during the review period. In drawing attention to any weaknesses or failures in the control system, they will be asked to report



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only those which, in their judgement, are material. Where weaknesses or failures in controls have been identified, the auditors should, if possible, make recommendations for improvement. It is not, however, the responsibility of the auditors to ensure that such recommendations are implemented by the AI.

- 4.2.11 A materiality test should also be applied in reporting any matters under §63(3A)(b). What constitutes material or adequate will need to be judged by the auditors on a case-by-case basis. In the case of an overseas incorporated AI, it is adverse matters which are material in the context of the AI's operations in Hong Kong which should be reported.

### 4.3 Ad hoc reviews

- 4.3.1 The MA also has a discretionary power under §59(2) of the Banking Ordinance to require an AI, after consultation with the AI, to provide an auditors' report on such matters as he may specify for the performance of his functions under the Ordinance. This power will, among other things, enable the MA to require an AI to appoint auditors to conduct a review on its internal control systems in specific areas of operations.
- 4.3.2 Major areas of control which may be covered in such a review include:
- corporate governance ([CG-1](#) "Corporate Governance of Locally Incorporated Authorized Institutions");
  - risk management system ([IC-1](#) "General Risk Management Controls");
  - controls relating to specific operational areas (e.g. lending or trading activities);





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- loan classification system ([CR-G-4](#) “Loan Classification and Provisioning”<sup>7</sup>);
- information technology ([TM-G-1](#) “General Principles for Technology Risk Management”);
- business continuity planning ([TM-G-2](#) “Business Continuity Planning”);
- prevention of money laundering ([ML-1](#) “Prevention of Money Laundering”<sup>8</sup>); and
- internal audit function ([IC-2](#) “Internal Audit, Legal and Compliance Function”<sup>9</sup>).

In determining the audit procedures of a review, the auditors may refer to the above relevant module(s) for guidance.

4.3.3 This type of report will be commissioned where an independent review is required in particular areas. The circumstances which may lead to a decision to commission a report include:

- a management letter<sup>10</sup> from the AI's auditors which revealed significant weaknesses in internal controls;
- particular issues arising from the HKMA's on-site and off-site examinations, prudential interviews, tripartite

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<sup>7</sup> This module is under development. For the time being see Guideline 5.7 “Loan Classification System” dated 02.09.94, Guideline 5.7.1 “Loan Classification System - Loans to be reported as Special Mention” dated 07.11.94, Circular “Banking Return on Loans and Advances (MA(BS)2A) – Definition of “Overdue Loans” in respect of Loans Repayable on Demand” dated 17.12.98, Circular “Amendments to the Quarterly Analysis of Loans and Advances and Provisions” dated 28.05.99, Circular “Guideline on Loan Classification System – Revision to the Guideline on Rescheduled Assets” dated 01.11.99 and Circular “Loan Classification and Provisioning” dated 08.11.99.

<sup>8</sup> This module is under development. For the time being see Guideline 3.3 “Prevention of Money Laundering” issued on 21.12.2000 and its Supplement issued on 31.03.2003.

<sup>9</sup> Module under development

<sup>10</sup> AIs are required to provide a copy of the auditors' management letter to the HKMA for review (see subsection 6.4 of [CG-1](#) “Corporate Governance of Locally Incorporated Authorized Institutions”).



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meetings, internal auditors' reports, external auditors' reports on annual accounts and ad hoc reports made by the auditors under §61 of the Banking Ordinance;

- frequent errors detected in returns submitted to the MA or other indications of irregularities in the returns;
- material adverse events or transactions which affect the business operations or financial position of the AI. These will include matters reported by the auditors under §§63(3), 63(3A), 63A or 63B; and
- significant exposure to business activities or new product lines which require strong systems support as part of the risk management process. An example is dealing in derivative instruments with a high degree of price volatility.

4.3.4 The MA may also use his powers under §59(2) to commission reports on other matters which are relevant to the exercise of his functions under the Ordinance, e.g. in relation to review of particular transactions. A report may also be commissioned on the financial affairs of the AI, based on an audit of its accounts. Such a report will only be commissioned where the MA has reason to believe that the normal audit by the AI's auditors was, or was likely to be, seriously deficient.

4.3.5 The period to be covered by a report under §59(2) will vary depending on the circumstances but it will not normally exceed 12 months. A report will be commissioned after prior consultation with the AI and its scope (i.e. terms of reference) will be agreed in advance with the AI and its auditors.

4.3.6 The scope of the review, the period to be covered and the due date for submission will be notified in writing to the AI. The AI should in turn issue a letter of instruction to its auditors with a copy to the MA.



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4.3.7 The auditors' report should normally be submitted to the AI not later than three months from the end of the review period and forwarded with the comments of the AI, if any, to the MA within a further month. The MA reserves the right to require a shorter deadline in special circumstances, after consultation with the AI and the auditors concerned.

## 5. Auditors' reporting on certain specified matters


### 5.1 Reporting of significant adverse matters

5.1.1 Under §63A of the Banking Ordinance, the auditors of an AI are required to submit a report in writing, as soon as is reasonably practicable, to the MA if they, in the course of performing their duties as auditors, become aware of a matter which, in their opinion, adversely affects the AI's financial position to a material extent. The report should cover the nature of the matter and the reason(s) why they are of that opinion.

5.1.2 In determining whether a matter should be reported to the MA under §63A, an AI's auditors should consider, among other things, the following issues:

- whether the AI's status as a going concern is questionable (e.g. a material loss that may threaten the financial condition of the AI);
- whether the AI's capital adequacy ratio has dropped, or will drop, significantly to a level which may be detrimental to depositors; or
- whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.

5.1.3 For locally incorporated AIs, the auditors should look at the matter in the context of the AI as a whole. If the AI concerned is incorporated outside Hong Kong, the auditors

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should consider any such matter in the context of its principal place of business in Hong Kong and its local branches as if that principal place of business and those branches were collectively a separate AI.

- 5.1.4 It is also an AI's responsibility to report to the MA if it becomes aware of such matters affecting its financial position. The AI should bring such matters to the attention of the MA as soon as it has reason to believe that they could have a material adverse effect on the AI or on the interests of depositors. Specifically, an AI is required to notify the MA under §67 of the Banking Ordinance if it is, or is about to become, unable to meet its obligations, and under §§99 and 103 of the Ordinance, where it fails to keep its capital adequacy or liquidity ratios at or above the prescribed levels.

## **5.2 Reporting of non-compliance with the SFO**

- 5.2.1 Under §63B of the Banking Ordinance, the auditors of an AI are required to submit a report in writing, as soon as is reasonably practicable, to the MA if they, in the course of performing their duties as auditors, become aware of any matter that, in their opinion, constitutes on the part of a registered AI a failure to comply with any prescribed requirements within the meaning of §157 of the SFO.
- 5.2.2 Under §157 of the SFO, "prescribed requirements" refer to the requirements of any rules made under §§148, 149, 151, 152 or 397 of the SFO. These requirements generally relate to the management of client securities and collateral, holding of client monies, keeping of accounts and records, provision of contract notes, receipts, statement of account and notifications, etc.
- 5.2.3 Given the nature of AIs' deposit taking business, the requirements relating to the holding of clients' monies under §149 of the SFO are specifically excluded for purposes of §63B of the Banking Ordinance.



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5.2.4 Auditors of registered AIs should therefore familiarise themselves with the relevant regulations and requirements issued by the SFC in order to fulfil their duties under §63B of the Banking Ordinance. Nevertheless §63B does not of itself require auditors to change the scope, nature and depth of their audit work<sup>11</sup>. They are not required actively to seek out grounds for making a report under this section. It is only when they become aware, in the ordinary course of their work, of a matter of the kind described in para. 5.2.2 above that they should make a report to the MA.

## 6. Communication between the auditors and the HKMA

### 6.1 Protection

6.1.1 §61 of the Banking Ordinance permits auditors, notwithstanding any duty which they may owe to their clients (e.g. confidentiality), to communicate with the MA, provided that:

- the communication, whether or not in response to a request by the MA, is in good faith; and
- the information so disclosed relates to information or opinion on a matter of which they become aware in the capacity of auditors and which is relevant to any function of the MA under the Ordinance.

6.1.2 The protection covers not only auditors appointed under §131 of the Companies Ordinance but also auditors appointed for the purpose of §§50(1)(c), 59(2), 63(3) and 63(3A) of the Banking Ordinance. It also covers auditors who make a report to the MA as required under §§63A and 63B of the Banking Ordinance.

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<sup>11</sup> It is acknowledged that the scope and extent of audit work on the securities dealing operation of an AI may vary from institution to institution, depending on the size of the operation.



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6.1.3 §61 of the Banking Ordinance does not protect the auditors if they fail to make a report as required under §63A or 63B of the Ordinance or when they might have been expected to have done so as described in para. 6.2.3 below.

6.1.4 The protection afforded by §61 of the Banking Ordinance is general and not restricted by the circumstances in which the information is obtained or by its sources. Provided the information becomes known to the auditors in the capacity as the auditors of an AI, they may communicate that information to the MA notwithstanding that:

- the information does not relate to the auditing work undertaken by them; or
- the source of the information was not the AI.

6.1.5 §61 of the Banking Ordinance does not of itself require auditors to change the scope, nature and depth of their audit work. They are not required to actively seek out grounds for making a report under this section. It is only when they become aware, in the ordinary course of their work, of any situation as described in para. 6.2.3 below that they should make detailed enquiries with §61 in mind.

## 6.2 Direct reporting to the HKMA

6.2.1 For matters required to be reported under §§63A and 63B of the Banking Ordinance, it is the auditors' obligation to report them directly (i.e. not via the AI) to the MA.

6.2.2 Apart from matters required to be reported directly by the auditors under §§63A and 63B of the Banking Ordinance, the MA recognises that it is important for auditors to act in a manner that will preserve their professional relationship with their client AIs. It is therefore expected that the auditors will normally discuss with their AI any matter about which they are concerned, and request the AI to draw the matter to the



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attention of the MA (or obtain evidence that shows that the matter has been reported to the MA).

6.2.3 Where an AI declines to report to the MA or the matter has not been brought to the attention of the MA within a reasonable period of time, the auditors should consider making a report directly to the MA in respect of any matter (other than those already required to be reported under §§63A and 63B of the Banking Ordinance) where they consider that depositors' interests might be better protected if the MA was made aware of it. Examples of such matters include:

- when there appears to the auditors to be a material contravention of one or more of the requirements of the Banking Ordinance;
- where the auditors have evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's assets;
- when the auditors form the opinion that there has been a significant failure of, or that there is a significant weakness in, the AI's accounting and other records or internal control systems; or
- when the auditors form the opinion that management has reported financial information to the MA which is materially misleading or become aware that management has failed or does not intend to report something and the failure to report is, or would be, materially misleading.

6.2.4 In exceptional circumstances, where it is in the interest of protecting depositors that the management of the AI should not be informed in advance, the auditors should report directly to the HKMA having first considered independent legal advice, as is deemed necessary. Examples of these circumstances are:



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- where there has been an occurrence which causes the auditors no longer to have confidence in the integrity of the directors or senior management, e.g.:
  - where they believe that a fraud or other misappropriation has been committed by the directors or senior management of the AI; or
  - where they have evidence of the intention of directors or senior management to commit a fraud or misappropriation;
- where there has been an occurrence which causes the auditors no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g.:
  - where they have discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the AI's affairs; or
  - where they have evidence of an intention so to act; and
- where the AI refuses or fails to inform the HKMA of a matter within the specified time period, having been advised to do so by its auditors, or where there is evidence that the AI has not adequately and properly reported the matter in question.

6.2.5 In these exceptional circumstances the auditors may wish to consider whether the matter should be reported at an appropriate senior level in the AI (e.g. audit committee) and whether an appropriate representative of the AI (e.g. an independent director) should be invited to attend a meeting with the HKMA. Decisions should be made in the light of the circumstances of each case.





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6.2.6 Speed of reporting may be important for the protection of depositors. Therefore, while the auditors may wish to take legal advice, they should also consider the possible impact on depositors' interest arising from a delay in reporting the matter to the HKMA.

### 6.3 Sharing of information with auditors

6.3.1 The MA is permitted under §120(5)(g) of the Banking Ordinance to disclose confidential information to an auditor of an AI or former AI or to a former auditor for the purpose of enabling or assisting the MA to discharge his functions under the Ordinance.

6.3.2 With this authority, the MA will take the initiative, normally by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditors when:

- he considers the matter of such importance that the auditors' knowledge of it could significantly affect the form of their audit or other report or the way in which they carry out their reporting responsibilities; and
- the disclosure is for the purpose of enabling or assisting the MA to discharge his functions under the Banking Ordinance or will otherwise be in the interests of depositors.

6.3.3 Information so disclosed to the auditors remains confidential and should not therefore be further disclosed unless the MA consents.

### 6.4 Tripartite meeting

6.4.1 Meetings involving the HKMA, an AI and its auditors may be called by any of these parties and convened at any time. Such meetings can be held on an ad hoc basis but for locally incorporated banks, they are normally convened on a yearly basis following the annual audit.



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- 6.4.2 Matters discussed in the tripartite meeting typically include the results of the annual audit, presentation and content of the annual accounts and the work performed under §§50, 59(2), 63(3) and 63(3A) (such as identified weaknesses in internal controls, adequacy of provisions and compliance with legal and other prudential requirements).
- 6.4.3 The HKMA will usually prepare an agenda for the tripartite meeting and include items at the request of the AI or its auditors. The auditors should forward any such request via the AI. An item may be included on the agenda even if the AI has not agreed. It may therefore be necessary for there to be direct communication between the auditors and the HKMA.
- 6.4.4 Auditors should be aware of the MA's functions under the Banking Ordinance and his responsibilities for the protection of depositors. They will be expected to participate fully in tripartite meetings. This will involve discussing matters relating to their client's affairs, including information about the customers of their clients, arising from the statutory audit and from work required under the Ordinance.
- 6.4.5 The HKMA recognises that it would not be appropriate for auditors to report to it any information about the AI obtained through their professional relationship with another client which is not the AI in question.

## 7. Industry guidance

- [7.1 The Hong Kong Society of Accountants has issued a Practice Note "The relationship between the Hong Kong Monetary Authority and authorized institutions' external auditors and reporting on regulatory returns" to provide more specific guidance to the auditors on the conduct of their work under the Banking Ordinance.]



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## Annex A: Controls relating to the compilation of prudential returns

### 1. Objective

Als should have adequate systems and controls to permit the submission of reliable statistics and information to the HKMA. The statistics and information submitted should be complete, accurate and prepared in accordance with the HKMA's completion instructions.

### 2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business. In developing the audit procedures, they may have regard to the following:

- A procedures manual is established, setting out the timing of reports, their compilation method, information sources used and other information gathering techniques which are necessary to ensure the complete, timely and accurate compilation of returns and other information;
- Clear, concise and organised working papers for the compilation of returns and other information are maintained to provide traceable links between the accounting records and completed returns. Any material discrepancies between the records and the returns are investigated and explained;
- The approach and procedures used in the compilation of returns and other information are clearly understood by the officers responsible for the preparation and checking. The various guidelines and instructions issued by the HKMA relating to the completion of returns are properly filed and kept up-to-date to facilitate future reference;
- Any questions or clarification regarding the compilation process are referred to the HKMA. A note of any discussions ~~are~~is made for future reference;
- Prior to submission, returns and other information are checked by a designated officer who takes no part in the actual preparation work; and
- Procedures are adopted to ensure that staffing changes do not affect the quality of returns and other information.



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### Annex B: Controls relating to compliance with statutory provisions in the Banking Ordinance

#### 1. Objective

Als should have effective monitoring and reporting systems to enable compliance with their statutory duties under the Banking Ordinance at all times.

#### 2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business. In developing the audit procedures, they may have regard to the following:

##### General controls

- Management are fully aware of the relevant statutory provisions and regulatory requirements in relation to the AI's operations;
- There is central filing of the Banking Ordinance, guidelines and circular letters issued by the HKMA (whether by mail or through electronic delivery), relevant communications with the HKMA and amendments to all these documents. There are also established procedures to ensure that such information are communicated effectively within the AI to those who need to be aware of it;
- A procedures manual is established to ensure compliance with statutory and regulatory requirements in all aspects of the AI's operations;
- Procedures are in place to ensure compliance with statutory and regulatory requirements before introduction of new products and engagement in new business activities;
- An officer (e.g. compliance officer) has been designated with the responsibility to monitor and ensure compliance with statutory and regulatory requirements;
- Adequate management reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant management members and the compliance officer in a timely manner;



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- Procedures are in place to ensure that any failure to comply with statutory or regulatory requirements is reported to the HKMA as soon as practicable; and
- Clear, concise and organised working papers for monitoring compliance are maintained to provide audit trails for subsequent verification.

### Compliance with §§81 and 83 of the Banking Ordinance

- There is a written policy on large exposures and advances to connected parties which sets out, among other things, the AI's strategy to prevent undue concentration of risks and, specifically, the systems and procedures to ensure compliance with statutory and regulatory requirements;
- Limits are established for customers or group of related customers to prevent any potential breach of the Banking Ordinance. Where appropriate, sub-limits should be allocated to, and observed by, business units, branches or subsidiaries. The limits and sub-limits should be set at levels lower than the statutory limits under §§81 and 83 of the Ordinance so as to ensure compliance on a continuous basis;
- The internal reporting and monitoring system is able to provide timely information for management's attention or action;
- A central liability record to ensure compliance with §§81 and 83 of the Ordinance is maintained to capture all financial exposures to relevant customers, including those extended through branches or subsidiaries, and that record is kept up-to-date at all times;
- Procedures are in place for effective control of facilities approved at a branch or subsidiary level and to ensure that such facilities are captured in the central liability record in a timely manner; and
- Financial exposures which are exempt from §§81 and 83 of the Ordinance are adequately monitored to ensure that the terms and conditions for exemptions are complied with at all times.

(See also [CR-G-8](#) "Large Exposures and Risk Concentrations" and [CR-G-9](#) "Connected Lending" for detailed guidance.)

### Compliance with §98 – Capital Adequacy

- A written policy is established to set out the AI's strategy on capital adequacy and how it intends to maintain adequate capital to support its



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various business activities and to meet statutory and regulatory requirements;

- Target capital ratios are set at a level above the trigger ratios to ensure continuous compliance;
- Capital adequacy budgets (on solo and consolidated basis where appropriate) are prepared annually, taking into account the projected asset mix, expected balance sheet growth and capital resources. Where appropriate, limits on balance sheet growth are imposed on business units, branches and subsidiaries;
- Systems and procedures are in place to enable the management to monitor its capital adequacy ratios (on solo and consolidated basis where appropriate) on a continuous basis; and that any adverse variance against the target ratio(s) and, particularly, any breach of the trigger or minimum ratios, should be reported to the chief executive immediately;
- The impact of large loans, major investments and other significant transactions on capital adequacy is assessed in advance; and
- Stress-testing on capital adequacy ratio is performed on a regular basis.

### Compliance with §102 – Liquidity

- A written policy on liquidity is established to set out the AI's strategy and procedures for maintaining adequate liquidity at all times and, specifically, to meet statutory and regulatory requirements;
- Target liquidity and maturity mismatch ratios are set at a level above the statutory ratio and any higher limits imposed by the HKMA to ensure continuous compliance;
- Systems and procedures are in place to enable the management to monitor the actual liquidity and maturity mismatch ratios on a continuous basis and, specifically, any breach of the target ratios is reported to the chief executive immediately;
- The impact of large loans, major investments and other significant transactions on liquidity is assessed in advance; and
- Stress-testing on the liquidity position is performed on a regular basis.

(See [LM-1](#) "Liquidity Risk Management" for detailed guidance.)



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### Annex C: Controls relating to the maintenance of adequate provisions

#### 1. Objective

Als should have adequate policies and procedures for assessing the quality of their assets regularly and for establishing adequate provisions for bad and doubtful debts.

#### 2. Key controls and procedures

Auditors should develop audit procedures to assess whether the AI has controls in place to satisfy the above objective, taking into account the nature, size and complexity of an AI's business. In developing the audit procedures, they may have regard to the following:

- Policies and procedures are established to set out the frequency, methodology and level of general and specific provisions (including country risk provisions as appropriate) to be maintained for each type of assets and off-balance sheet exposures, and contingent liabilities;
- A multiple-grade loan classification system is established to monitor asset quality on a regular basis. The sophistication of the system should be in line with the nature, size and complexity of the AI's business. It should have a clear definition for each loan grade and respective classification criteria that consist of both qualitative and quantitative factors;
- Minimum levels of provision are set for each loan grade under the loan classification system;
- Procedures are established for reviewing and setting aside general and specific provisions on a regular basis;
- Specific officers or committees are charged with the responsibility for approving and reviewing general and specific provisions;
- Procedures are in place to ensure that the provisioning decisions and the basis for these decisions are recorded and reported to senior management or a relevant committee (e.g. credit committee) on a regular basis. Where appropriate, such information should also be reported to the Board; and



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- Procedures are in place for:
  - the monitoring of asset quality and loan concentration by country and sector;
  - the monitoring of adverse economic or political factors which might affect the quality of the loan portfolio or particular types of borrowers;
  - the monitoring of overdue and rescheduled assets;
  - the review of irregularities in individual credit exposures;
  - the review of borrowers' and guarantors' financial positions;
  - the review of and updating of value of collateral on a regular basis; and
  - the suspension or cessation of interest accrual for classified assets.

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