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Practice Note 830

Reports by Auditors Under the Banking Ordinance



Hong Kong Institute of
Certified Public Accountants
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PRACTICE NOTE 830

REPORTS BY AUDITORS UNDER THE BANKING ORDINANCE

(Issued January 2005; Effective upon issue)

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<p>Practice Note (PN) 830, “Reports by Auditors Under the Banking Ordinance” should be read in the context of the “Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services” which sets out the application and authority of PNs.</p>
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PART I – INTRODUCTION

1. In this Practice Note (“PN”) all the sections mentioned below are in respect of the Banking Ordinance (“Ordinance”) unless otherwise stated.
2. The purpose of this PN is to assist auditors of authorized institutions (“AIs”) in reporting under the Ordinance.
3. This PN provides guidance to members on the reporting responsibilities of auditors appointed for the purposes of sections 50(1)(c), 59(2), 63(3) and 63(3A). Guidance is also provided on other reports and notifications issued by auditors, including notification of audit qualifications or adverse statements under section 59A(2)(c), reporting of significant adverse matters and non-compliances under sections 63A and 63B, notification of resignation of auditors under section 59A(2) and report of factual findings in relation to voluntary revocation of authorization of an AI. These are dealt with in Part II.
4. Guidance on auditors’ ad hoc communications with the Hong Kong Monetary Authority (“HKMA”) under the protection of section 61 is set out in Part III.
5. This PN is not intended to provide detailed guidance on the general audit procedures to be adopted in respect of the audits of the financial statements of AIs and does not apply to other reports provided by auditors, such as those provided under the Companies Ordinance on financial statements and on the statement of loans to officers. Guidance on auditors’ reports on financial statements is set out in SAS 600, “Auditors’ Reports on Financial Statements” and guidance on auditors’ reports on the statement of loans to officers is set out in Industry Auditing Guideline 3.406, “Banks and Deposit-taking Companies – the Amended Section 161B and Section 161BA of the Companies Ordinance”.
6. In addition to the reporting responsibilities under the Ordinance, auditors are required to report to the relevant authorities in accordance with the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance for the purpose of combating money laundering and terrorism. This PN does not provide guidance in this regard.
7. This PN also contains in Appendix 5 a guide to the relevant provisions for auditors in the Ordinance which were effective as at 31 October 2004. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this PN should be used in conjunction with the legislation.
8. It should be borne in mind that certain expressions used in the Ordinance may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this PN, members will wish to seek legal advice.
9. The term Monetary Authority in the Ordinance refers to a person appointed by the Financial Secretary under the Exchange Fund Ordinance. The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability and is headed by the Monetary Authority. In this PN, the term “HKMA” is used generally to refer to the organization as a whole. The term “Monetary Authority” is used when quoting a specific reference from the Ordinance and in the auditors’ reports under the Ordinance.
10. The PN has been prepared in consultation with the HKMA.

PART II – AUDITORS’ REPORTING RESPONSIBILITIES UNDER THE ORDINANCE

Introduction

11. Auditors are normally appointed by the AI with the approval of the HKMA for the purpose of preparing certain reports under the Ordinance. The Ordinance generally recognizes auditors as persons appointed by the shareholders of a locally incorporated AI under the Companies Ordinance to report on whether the AI’s financial statements give a true and fair view (“statutory auditors”) or those appointed by the AI to submit a report to the HKMA under section 59(2), 63(3) or 63(3A). Submission of reports by auditors under the Ordinance (except reporting under section 59(2)) is normally carried out by an AI’s statutory auditors although the HKMA has the right to commission reports from another firm of auditors where:
- a. such an arrangement can better utilize the knowledge and expertise of different auditors which may be beneficial to the AI; or
 - b. the HKMA has reason to believe that the statutory auditors would not be capable of producing an adequate report, after taking into account:
 - the reputation of the statutory auditors;
 - the quality of reports previously submitted to the HKMA by the statutory auditors;
 - the expertise, knowledge and resources of the statutory auditors; and
 - any potential conflict of interest on the part of the statutory auditors.

Even where there are no doubts about the capability or independence of the statutory auditors, the HKMA may require that a report under section 59(2) be obtained from another firm of auditors to obtain a fresh perspective on matters which are the subject of the report.

12. Auditors have a number of reporting responsibilities under the Ordinance. These include:
- a. Regular reports
 - Reporting on specified banking returns (section 63(3)) (see paragraphs 38 to 65 below);
 - Reporting on systems of control over the compilation of banking returns, compliance with specified sections of the Ordinance and maintenance of adequate provision (section 63(3A)) (see paragraphs 66 to 102 below).
 - b. Other reports
 - Ad hoc reporting on internal controls, specific transactions or any other matters (section 59(2)) (see paragraphs 103 to 125 below);
 - Notification of audit qualifications or adverse statements in audit reports on AI’s financial statements (section 59A(2)(c)) (see paragraphs 126 to 128 below);
 - Reporting of significant adverse matters and non-compliances (sections 63A and 63B) (see paragraphs 129 to 137 below);
 - Notification of resignation of auditors (section 59A(2)) (see paragraph 138 below).
 - c. Under section 50(1)(c), locally incorporated AIs which maintain an overseas branch may need to appoint auditors, if the HKMA 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).

13. Auditors are also normally requested to furnish a report on voluntary revocation of an AI's authorization to the HKMA in respect of the balance sheet, third party deposit liabilities, contingent liabilities and outstanding commitments (see paragraphs 139 to 144 below).
14. The HKMA issues specific completion instructions and guidelines to AIs on the compilation of banking returns and on meeting the provisions of the Ordinance. In its Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance", the HKMA also provides a description of the nature of some of the controls and procedures it expects AIs to have in place to demonstrate adequate controls over compilation of banking returns and compliance with the provisions in the Ordinance. Auditors would have regard to the requirements set out in Supervisory Policy Manual IC-3 in fulfilling their reporting responsibilities under the Ordinance.

General guidance

Types of engagements under the Ordinance

15. Auditors' reporting responsibilities under the Ordinance can generally be categorized as either reasonable assurance engagements, limited assurance engagements, or agreed-upon procedures engagements.
16. The objective of a reasonable assurance engagement is for the auditors to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a reasonable level of assurance about the subject matter in a positive form.
17. The objective of a limited assurance engagement is for auditors to obtain sufficient appropriate evidence to be satisfied that the subject matter is plausible in the circumstances and this provides the basis for a negative form of expression of the auditors' conclusion.
18. The objective of an agreed-upon procedures engagement is for the auditors to carry out procedures of an audit nature to which the auditors and the entity and any appropriate third parties have agreed, and to report on factual findings. As the auditors simply provide a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report would assess for themselves the procedures and findings reported by the auditors and draw their own conclusions from the auditors' work.

Overview of the reporting process

19. The following are action steps that auditors would consider in order to discharge their reporting responsibilities under the Ordinance:

a. Scoping and planning

For reporting under section 63(3) and (3A):

- Assemble the engagement team including any necessary specialists;
- Obtain from the AI the terms of reference (normally called a "Letter of Instruction") identifying the banking returns or systems of control to be reported on and the period to be covered;
- Issue a letter of engagement;
- Obtain the relevant banking returns to be reported on from the AI (if applicable);
- Undertake detailed planning and fieldwork.

For reporting under section 59(2):

- Obtain the draft scope of review prepared by the HKMA and discuss the nature of the appointment with the AI;
- Seek a meeting with the HKMA (at which representatives of the AI would normally be present) to obtain the background information, including the reasons why the HKMA is requesting the report;
- Where necessary, hold scoping meeting(s) with the HKMA and the AI to further refine the scope;
- Agree the scope and all other matters that are to be recorded in the Letter of Instruction with the AI and the HKMA;
- Obtain from the AI the Letter of Instruction;
- Issue a letter of engagement to the AI, incorporating the Letter of Instruction;
- Undertake detailed planning and fieldwork.

b. Execution

- If requested by the HKMA, or if considered necessary as a result of issues identified whilst conducting the work, arrange discussions or meetings with the HKMA and/or the AI;
- Incorporate the responses of management (obtained in writing) of the AI to the findings in the final report (if this is the agreed means of communicating management's comments to the HKMA);
- For engagements under section 59(2), arrange with the AI and the HKMA to amend or reissue the Letter of Instruction to reflect any significant matters that come to light during the performance of the work and any changes in scope verbally communicated to the AI or the auditors (if necessary).

c. Finalization and reporting

- Finalize the report with the AI's management comments or responses included, where appropriate;
- Obtain a management representation letter from the AI;
- Issue the final report to the AI for submission to the HKMA;
- For reports under section 59(2), if comments from the AI's management on the draft final report were not incorporated into the auditors' report, obtain a copy of the comments sent by the AI to the HKMA;
- Prepare for and attend any tripartite meeting to discuss the report findings (if necessary).

20. The scope of an engagement under section 63(3) or (3A) is normally considered to be relatively routine and standardized and therefore, some of the above action steps may have been addressed previously and can be carried over into the current period engagement.

Engagement acceptance

21. When undertaking an engagement to provide a report under the Ordinance, auditors would recognize that throughout the process, there are two parties interested in the report - the AI which engages the auditors; and the HKMA, which has required the AI to commission the report. Auditors would manage the expectations of both parties to reduce the risk of misunderstanding.
22. Auditors would ensure that the scope of the engagement is clear, so that the HKMA and the AI agree, accept and understand the areas to be examined, the form of reporting of the overall findings, the content and structure of the report to be provided and the type and extent of procedures to be undertaken. However, it is the responsibility of the HKMA to determine whether the scope of the work specified in the Letter of Instruction is sufficient for its purposes.
23. For reporting under section 59(2), the HKMA recognizes that normally there will be value in holding discussions involving auditors concerning the proposed assignment in a tripartite meeting (between the AI, the HKMA and the auditors) or, in less usual circumstances, a bilateral meeting (between the HKMA and the auditors only) but is not bound to do so. This discussion can occur when a draft scope has already been prepared by the HKMA and this would form the basis for the discussion.
24. When approached to undertake an engagement to report under the Ordinance and during the discussion of the scope, auditors would consider the professional skills required to undertake the engagement.
25. In particular, auditors would need to have knowledge and understanding of the HKMA's regulatory requirements and the statutory provisions relevant to the scope of the engagement. This is necessary in order to understand and evaluate the scope of the engagement at the outset, and to determine the manner in which the findings in the auditors' report would be presented. In addition, auditors are required to report, in certain circumstances and without delay, direct to the HKMA and therefore would need to be aware of the relevant provisions.
26. Auditors would need to consider whether previous or existing professional relationships could present a conflict of interest in accepting the engagement. If auditors become aware of relationships with the AI which could be construed as a conflict of interest, the auditors would advise the AI and the HKMA of this issue and all parties have to be satisfied that the auditors are appropriately placed to undertake the assignment objectively.
27. The HKMA has indicated that it would take into account the knowledge and expertise of the statutory auditors and the need for a fresh perspective on matters to be examined when deciding whether to nominate or approve the appointment of the statutory auditors or another firm of auditors.
28. Auditors and the AI would agree on the terms of the engagement, which would be recorded in an engagement letter or other suitable form of written contract. Auditors would follow the guidance set out in SAS 140, "Engagement Letters" or HKSA 210, "Terms of Audit Engagements" when it is finalized and agree the terms of the engagement in relation to the auditors' work performed under the Ordinance.
29. Examples of engagement letters are set out in Appendix 3 to this PN.

Reporting considerations

30. Generally, when making a report, auditors would apply techniques to keep narrative in the report clear, logically structured and concise, such as using bullet points and tables, and relegating detailed elements to the detailed sections and appendices to the report. Auditors would include specific findings such as exceptions, weaknesses, observations or required recommendations (however defined) arising from the work undertaken together with sufficient background information for the HKMA and the AI to understand the context in which the findings are made and their implications.

31. Auditors would need to be aware that specific findings included in the report can form the basis of supervisory or enforcement action by the HKMA. Therefore, it is important that all relevant matters, which are considered material in the circumstances, be included in the report. When evaluating whether and how to report a specific finding, auditors would need to recognize that materiality for reporting under the Ordinance may be different to that used in the context of an audit of the financial statements of the AI or an assignment undertaken solely for the AI's management. Auditors would take into account the HKMA's interests in its role as a supervisor, for example by considering the findings in the context of: the HKMA's supervisory objectives; requirements set out in the HKMA's Supervisory Policy Manual in relation to the area examined; and the HKMA's reasons for commissioning a report, including any concerns or issues raised during the scoping discussions. It may also be useful for auditors to discuss and agree with the HKMA and the AI on the materiality threshold so that what would constitute a matter to be reported as a specific finding and how it will be described are clearly understood between all parties.
32. The materiality threshold is a matter of professional judgment but, unless otherwise agreed with the HKMA, auditors would normally report all relevant matters other than those considered to be immaterial. This PN provides further guidance for auditors on materiality for the purpose of their reporting responsibilities under the Ordinance (see paragraphs 60, 93 to 97 and 118 to 119 below for different engagements).
33. Unless otherwise agreed with the HKMA, where an auditors' engagement for the purpose of reporting under the Ordinance includes the examination of controls over a specified period or transactions during that period, auditors would include all material findings identified even if the findings identified were corrected during or after the period examined.
34. Auditors would seek management's confirmation of the factual accuracy of information or statements contained in their report. This may be achieved either by way of a written confirmation from management or as a specific representation from management included in the management representation letter. Examples of management representation letters are set out in Appendix 2 to this PN.

Obtaining management comments

35. The HKMA expects management of the AI to have the opportunity to provide written comments on the auditors' report prior to its submission to the HKMA. Management may wish to provide auditors with written comments for incorporation into the auditors' report prior to its issue. Alternatively, management of the AI may choose to provide written comments directly to the HKMA when the AI submits the report to the HKMA.
36. Where auditors include management comments in the report prior to its issue, the report would clearly identify the comments of management. The report would also state clearly that the management of the AI is responsible for the accuracy of the comments made, that auditors take no responsibility for them and that they are not covered by the auditors' conclusion (or overall findings otherwise provided). A common practice used in the presentation of management letters or internal control reports, which can assist the review of an auditors' report by the HKMA, is to incorporate management comments in the body of the report, against the elements of the report to which the comments relate.
37. Management comments for incorporation in the auditors' report prior to issue would be obtained from, or confirmed in writing by, the AI in order to minimize the risk of error or misunderstanding. Where auditors issue a report without incorporating management's comments, they would obtain a copy of any comments that management submits directly to the HKMA.

Auditors' reports under section 63(3)

General

38. Management of AIs is required by the HKMA to submit a number of returns within an integrated banking statistics system. The HKMA may also require an AI to submit a report, prepared by the auditors, as to whether or not, in the opinion of the auditors, a return submitted to the HKMA is correctly compiled, in all material respects, from the books and records of the AI and, if not so correctly compiled, the nature and extent of the incorrectness. General guidance on auditors' reports on banking returns is provided in the HKMA's Supervisory Policy Manual IC-3.
39. Preparation and submission of the banking returns is the responsibility of the AI's management. The Ordinance makes it an offence for any person who signs any document for the purposes of section 63 which is known or ought to be known to be false in a material particular. Under section 123, it is also an offence for directors, chief executives, managers, trustees, employees and agents of an AI to wilfully deceive by falsifying books and records.
40. The HKMA has emphasized the importance of the banking returns submitted by AIs and can exercise the powers derived from section 63(3) (and section 50(1)(c)) to require AIs to appoint auditors to examine and report upon the banking returns submitted to the HKMA and any other returns which are used for prudential purposes to enable or assist the HKMA to exercise its duties and functions under the Ordinance. On occasion, the HKMA may require information in addition to the information contained in standard returns. Such information could also fall within the scope of information to be reported upon by auditors if it is requested by the HKMA under section 63(2).
41. These reporting arrangements are intended to reassure the HKMA about the reliability of the information received from an AI. It will be for the HKMA to determine, in the light of all the information available to it, the type of action, if any, that would be taken for its prudential supervision purposes.

Scope

42. The work that auditors perform for the purpose of reporting under section 63(3) is a reasonable assurance engagement. The responsibility for correct compilation of returns rests with the management of the AI and the auditors' responsibility is to report on whether the AI's returns are correctly compiled, in all material respects, from the books and records of the AI based on procedures they performed. Reference would be made to Hong Kong Standard on Assurance Engagements (HKSAE) 3000, "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" for details of the standards and guidance on reasonable assurance engagements.
43. Under section 63(3), the HKMA can require particular returns to be reported on by auditors. It should also be noted that for certain returns, auditors would normally report only on specified parts of the return. For a locally incorporated AI, auditors would normally be required to report on:
 - Return of Capital Adequacy Ratio (All parts);
 - Return of Large Exposures (Parts I, II and III, columns 1 – 5);
 - Return of Liquidity Position (Part I); and
 - Certificate of compliance with the Ordinance (Parts I – III).

Overseas incorporated AIs operate in the form of a branch in Hong Kong are not required to maintain a minimum capital adequacy ratio in respect of the branch. Accordingly, auditors would normally be required to report on:

- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part I); and
- Certificate of compliance with the Ordinance.

The HKMA can require a report on any return or other information submitted to it under section 63(1) and (2) (and section 50(1)(a) and (b)).

44. The returns to be reported on are normally the most comprehensive in the series. That is, where an AI completes a consolidated return, it will be that return which would be reported on. Where it has no subsidiaries, but has overseas branches, it will be the combined return that would be reported on. The HKMA normally selects only one date for the returns to be reported on per year, but may select other returns and dates if it believes the returns are not being completed properly. The date/period will not necessarily coincide with the end of the AI's financial year. The date will be determined by the HKMA retrospectively after the due submission date of the returns concerned.
45. When errors are identified in the returns submitted to the HKMA, AIs would, depending on materiality, make suitable amendments to the returns and re-submit these to the HKMA. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has indicated that the returns to be reported on by the auditors would be the returns originally submitted to the HKMA unless the HKMA specifies otherwise.

Nature of work

46. The work to be carried out for the purpose of reporting under section 63(3) involves agreeing amounts contained in the relevant returns to appropriate records maintained by the AI and checking whether the amounts have been properly compiled based on the completion instructions issued by the HKMA.
47. The auditors would review copies of the following documents when planning their work:
 - a. in respect of locally incorporated AIs, if they are not the statutory auditors, the latest audited financial statements of the AI together with a copy of the latest management letter issued by the statutory auditors where relevant. They would also seek the AI's permission to discuss any matters relevant to their examination with the statutory auditors (for co-operation between auditors);
 - b. all correspondence and all minutes or notes of meetings that the AI has held with the HKMA which are relevant to the auditors' examination of the internal control systems in relation to relevant returns;
 - c. all board and management committee minutes;
 - d. the returns originally submitted to the HKMA or those which the HKMA has specified otherwise, together with any amendments submitted thereafter.

Testing

48. The nature of testing required will vary from AI to AI as this will be dependent on the nature of the systems and processes used to produce the necessary information for compilation of the returns (e.g. whether processes are automated or performed manually).
49. An engagement under section 63(3) requires auditors to state whether, in their opinion, the returns have been correctly compiled, in all material respects, from the books and records of the AI. Accordingly, the work auditors are expected to perform on specified returns normally involves agreeing relevant amounts in the returns to the AI's books and records and ensuring that the compilation procedures were performed in accordance with the completion instructions issued by the HKMA for the relevant returns.
50. The definition of books and records is not specifically set out in the Ordinance. However, the HKMA would expect the information contained in the returns to be consistent with the books and records of the AI. Auditors would consider books and records to include the general ledger (including sub ledgers) and records or reports produced by systems (e.g. loan processing systems) which contain or explain in more specific detail particular items in the

general ledger (e.g. exposures to specific counterparties or a breakdown of balances by maturity buckets) and other records which support particular items in the returns such as off-balance sheet exposures.

51. There is no requirement for auditors to provide an opinion that the books and records are correct and complete but only that the amounts in the return agree with those books or records. It would normally be sufficient to check all items in the return to the working papers used by the AI to prepare the return and to check, on a sample basis, the compilation of the amounts contained in such working papers to the general ledger. For more detailed information reported in certain returns, it may be test checked to reports generated from established systems which reconcile to the general ledger.
52. In testing for completeness and accuracy, auditors would also trace on a sample basis the extraction of information contained in the accounting and other records to the relevant returns. Any material adjustments made to the accounting and other records in the course of compiling the returns would be considered for reasonableness. Auditors would also examine the compilation procedures to ensure they are consistent in all material aspects with the HKMA's current completion instructions (including notes and definitions) and any further written rulings that apply specifically to the particular AI.
53. As the auditors' work normally involves testing items on a sample basis, the auditors would consider the adequacy of the compilation process adopted in the preparation of the relevant returns as part of their determination of the sample sizes. For example, auditors would consider whether the definitions and interpretations used in compiling the information are appropriate, whether the controls are adequate to prevent and identify errors, and whether known issues are taken into account in the compilation process. Auditors would refer to SAS 430, "Audit Sampling" or HKSA 530, "Audit Sampling and Other Means of Testing" when it is finalized for further guidance in this regard.
54. On occasion, different interpretations of a particular definition or the requirements of the completion instructions may give rise to different results being reported in the returns. This is important as definitions and requirements set out in the Ordinance and the HKMA's completion instructions are typically worded in a general fashion and management would need to determine how such definitions or requirements would be applied to specific businesses or processes of an AI. Where issues relating to interpretation of the requirements or definition arise, the auditors would consider the following procedures in order to determine whether appropriate interpretation has been adopted:
 - Obtain a detailed understanding of the facts and rationale supporting the interpretation adopted by the AI;
 - Review relevant definitions and interpretations contained in the Ordinance, relevant completion instructions and industry practices;
 - Request that the AI discusses the issue with relevant officials of the HKMA and seeks written clarification thereon which would include the rationale for any conclusions drawn;
 - Consider the need to confirm the interpretation directly with relevant officials of the HKMA;
 - Determine the need to include an appropriate description of the interpretation adopted to form the basis of the opinion within the auditors' report.
55. When evaluating the manner in which a specific finding would be reported, the auditors would take into account the requirements of guidelines issued by the HKMA.

General procedures

56. The general procedures which auditors would carry out in respect of their work on the examination of returns for the purpose of reporting under section 63(3) include:

- Obtain an understanding of the purpose of the returns and the completion instructions for the relevant returns;
- Review correspondence between the AI and the HKMA to determine whether specific treatments for reporting items in the returns were agreed and adopted by the AI and whether the HKMA has granted specific exemptions to certain requirements for the particular AI;
- Ascertain whether the AI is required to prepare a consolidated return and, if so, determine the entities that are to be included by reviewing the relevant instructions or correspondence issued by the HKMA;
- Test check the calculations on the returns;
- Test check items from the returns to the working papers used by the AI to prepare the returns;
- Test check balances from working papers used by the AI to books and records and vice versa;
- Check that the compilation of amounts in the returns is in accordance with the relevant completion instructions and definitions;
- Ensure that only amounts which meet the relevant criteria are included in specific line items;
- Reconcile totals to the general ledger where appropriate.

Procedures pertaining to specific returns

57. Auditors would ensure that appropriate procedures are designed and carried out to gain adequate assurance that the returns are compiled correctly from the books and records. The specific compilation procedures of each return would vary depending on the requirements of particular return as set out in the completion instructions and other guidelines issued by the HKMA. Auditors would perform tests on the compilation procedures to determine whether they meet the requirements of completion instructions and relevant guidelines issued by the HKMA. Particular areas which auditors would take into consideration in examining returns which normally fall within the scope for reporting under section 63(3) are highlighted below for reference purposes:

a. Capital Adequacy

- Check that reserves have been appropriately classified under the categories of “Core capital” and “Supplementary capital”;
- Perform checks to ascertain whether the amounts and nature of items recognized as “Supplementary capital” are in accordance with the limits and any specific guidance on criteria established by the HKMA in the completion instructions and in the HKMA’s Supervisory Policy Manual and other guidelines in respect of “Supplementary capital”;
- Perform checks to ascertain whether the specified items are deducted from the total capital base in accordance with the completion instructions;
- Check that the AI has properly applied the appropriate risk weights to its on- and off-balance sheet exposures taking into account the type of instrument or exposure, the nature of counterparties and the maturity of the exposure;

- Review the method adopted by the AI in calculating the credit exposures of its exchange rate and interest rate contracts and check that the adoption of such a method has been agreed with the HKMA.

b. Large Exposures

- Obtain an understanding of how the AI captures and reports connected parties and transactions;
- Obtain a list of connected parties (as defined in the completion instructions) and perform procedures to ascertain completeness;
- Perform procedures to gain assurance that counterparties which are connected in a way that the financial soundness of one may affect the financial soundness of another are identified and that exposures to such counterparties are captured and aggregated for reporting purposes;
- Perform sample checks on individual exposure amounts to determine whether on- and off-balance sheet direct exposures are captured and whether indirect exposures (e.g. guarantees granted by the counterparty) are also appropriately identified and reported;
- Perform sample checks to ascertain whether exposure amounts (aggregating all facilities) for individual counterparties or groups of counterparties have been captured on a daily basis and that the maximum exposure is identified from the daily reported exposures;
- Identify the nature of counterparties or groups of counterparties to ensure the correct classification within the relevant parts of the return.

c. Liquidity

- Perform sample checks to ascertain whether various types of liquefiable assets and qualifying liabilities have been appropriately classified according to their nature, the remaining term to maturity, and that they qualify for inclusion as liquefiable assets and qualifying liabilities according to criteria set out in the Fourth Schedule of the Ordinance;
- Identify whether the HKMA has given approval to the AI to calculate the average monthly liquidity ratio on the basis of specified days during the month and perform checks to ensure that the AI calculates the ratio on the basis agreed with the HKMA;
- For the purpose of calculating the lowest liquidity ratio during the month, perform checks to ensure that the AI determines the ratio as the lowest liquidity ratio recorded at the close of business on a working day, or specified day and the last calendar day of the month, as the case may be, during the month covered by the return.

d. Compliance

- Check that the capital base reported agrees to the amount reported in the Return of Capital Adequacy Ratio at the previous quarter end*;
- Perform checks on the collateral records maintained by the AI to determine whether the shares of the AI, its holding, subsidiary or fellow subsidiary companies are held as security for loans and other credit facilities;
- Perform checks on compliance with the requirements under sections 80, 81*, 83*, 85, 87*, 87A*, 88*, 90* and 106* during the reporting period;

- Obtain correspondence setting out the minimum capital adequacy and liquidity ratios set by the HKMA for the AI for the purpose of compliance with sections 98* and 102;
- For items 1-7 under Part III of the return, check that daily closing exposures were used in reporting the maximum exposure and that the amount reported excludes those items which were exempted under sections 81, 83, 87 and 88*;
- Check the calculations for the maximum ratio of pledged assets and ensure the amounts used were correctly extracted from the AI's register of charges or other appropriate books and records*;
- Review legal correspondence for civil proceedings which may have a material impact on the financial position of the AI and confirm with management that it has notified the HKMA of any such proceedings*.

** applicable for locally incorporated AIs only*

Representations by management

58. Auditors would follow the guidance in SAS 440, "Representations by Management" or HKSA 580, "Management Representations" when it is finalized and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management's responsibility for establishing and maintaining adequate accounting records and systems of control to ensure that the returns have been correctly compiled from the books and records of the AI and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that all transactions undertaken by the AI have been properly reflected and recorded in accounting and any other records and for the compilation of the returns, such records properly reflect the true nature of all transactions;
 - c. management has made available to the auditors all relevant information (e.g. records and documents, procedures manuals, instructions and correspondences with the HKMA, etc.) for the purpose of the auditors' examination of the returns;
 - d. stating whether there have been any communications between regulatory authorities and the AI concerning non-compliances with or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the information presented in the returns;
 - e. the returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the HKMA;
 - f. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period; and
 - g. management has read the draft auditors' report and confirms the factual accuracy of information and statements contained in the draft auditors' report.
59. An example management representation letter is set out in Appendix 2 to this PN – Example 1.

Materiality

60. The HKMA only requires errors which are material in amount or indicative of weaknesses in the compilation process to be reported. What constitutes material will need to be judged by the auditors on a case-by-case basis but the focus is on the quality of the statistics provided

rather than on minor reporting errors. As a general rule the HKMA has stated in its Supervisory Policy Manual IC-3 that an error should normally be considered material if it exceeds 5% of the applicable item in the return to which it relates. It should also be noted that in addition to quantitative differences on a particular line item, auditors would also consider the impact of errors in a particular line item on other parts of the return or on other returns subject to examination.

Reporting

61. Each error or exception considered to be material would be reported together with an appropriate description of the error as well as the impact on the relevant return. Such errors would include those identified by the auditors or amendments made by the AI subsequent to the submission of the return under examination.
62. Where exceptions are identified and there is evidence to suggest that weaknesses in internal controls exist, the auditors would also consider including in the report under section 63(3A) their observations and recommendations on the relevant internal controls for the HKMA and the AI to gain a fuller understanding of the implications of their findings (see paragraphs 98 to 102 below).
63. An identical copy of the returns on which the auditors' report is based would accompany the auditors' report. Errors or exceptions would be set out either within the body of the auditors' report or in an appendix, reference to which is made in the auditors' report.
64. The auditors' report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. As a reasonable assurance engagement, the report issued by auditors would comply with the requirements set out in HKSAE 3000 and a statement that the engagement was conducted in accordance with HKSAE 3000 would be included in the auditors' report. The auditors' report would be completed, dated and submitted to the AI. Normally, the report by the auditors has to be submitted to the AI within two months from the date of the notification from the HKMA and the AI would forward the auditors' report together with any comments thereon within a further one month. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.
65. Examples of auditors' reports under section 63(3) are set out in Appendix 1 to this PN – Examples 1 and 2.

Auditors' reports under section 63(3A)

General

66. It is the responsibility of an AI's directors and management to ensure that adequate systems of internal control are maintained. It is the responsibility of the HKMA to judge whether an AI has maintained adequate systems of internal control as part of its overall assessment as to whether all the criteria for authorization are being met.
67. As a supervisor, the HKMA is concerned with obtaining evidence to enable it to form a view as to whether the prudential requirements on internal control systems are met. The HKMA will do this, inter alia, by considering any evidence provided by the auditors.
68. The HKMA has interpreted the requirements of the Ordinance in various modules of its Supervisory Policy Manual. Auditors would need to be familiar with the contents of the guidance contained in these modules of Supervisory Policy Manual to the extent relevant to the specific examination requested by the HKMA.
69. The HKMA will require AIs to appoint auditors to report to the directors of a locally incorporated AI or the chief executive of a Hong Kong branch of an overseas incorporated AI whether, in the auditors' opinion, certain internal control systems have been maintained by the AI throughout the period examined in accordance with the requirements of the Ordinance. In

forming their opinion, the auditors would have regard, inter alia, to the nature and scale of the business of the AI. Auditors will also be required, after forming an opinion on the specified internal control systems, to report on other matters contained in section 63(3A)(b).

70. An engagement to express an opinion on an AI's systems of control for the purpose of the Ordinance differs in purpose and in scope from a study and evaluation of the systems made as part of an audit of financial statements in order to express an opinion on whether those statements give a true and fair view. Given these differences, the auditors are unlikely to be able to rely solely on their work carried out for the purpose of auditing the financial statements and therefore they would adopt additional procedures for the purpose of reporting under section 63(3A).
71. The scope and period to be covered by the report under section 63(3A) will normally be notified in writing to the AI and copied to the auditors.

Scope

72. The work that auditors perform for the purpose of reporting under section 63(3A)(a) is an engagement providing reasonable assurance. The responsibility for adequate internal controls rests with the directors and management of the AI and the auditors' responsibility in providing reasonable assurance is to report on whether certain internal controls were in place during the relevant period. Having performed their work, auditors are then required to report under section 63(3A)(b) on whether they are aware of any material contraventions of certain provisions under the Ordinance by the AI and in addition, for locally incorporated AIs, any failure to maintain adequate provision. This assurance is based not only on the work performed under section 63(3A)(a) but would also take into account any other relevant information which comes to their attention as auditors in the normal course of their audit work or in their examination of returns under section 63(3). Auditors will not, however, be expected to change the scope of their audit work nor the frequency or timing of their audit visits. Reference would be made to HKSAE 3000 for details on the standards and guidance in this regard.
73. The HKMA is empowered under section 63(3A)(a) to require an AI to submit a report by auditors on whether, during a specified period, the internal control systems of the AI were adequate to enable, as much as is practicable:
- a. the AI's returns or information to be correctly compiled, in all material respects, from the books and records of the AI;
 - b. the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance;
 - c. in the case of a locally incorporated AI, the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
74. Having completed the work on the specified internal controls, the auditors would then report under section 63(3A)(b) in respect of the same period on whether:
- a. there appears to be any material contravention by the AI of any of its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance, and, if it so appears, the nature of the contravention and the evidence therefor; and
 - b. in the case of a locally incorporated AI, there appears to have been any failure by the AI to maintain adequate provision.
75. The period covered by a report under section 63(3A) will not normally be more than 12 months unless the HKMA is of the view that a longer period is necessary in the interest of

depositors or the public. Usually the period covered will be the financial year. Only one report is required to be submitted under section 63(3A).

Nature of work

76. The nature of the work to be carried out will be to determine whether appropriate internal controls exist and test the effective functioning of such internal controls. Testing would, therefore, be designed to determine whether the control procedures are being performed effectively. It should also be noted that the adequacy of controls would be assessed with reference to Supervisory Policy Manual and guidelines issued by the HKMA and taking into account the nature of business and size of the operation of the AI. For example, if the control being tested was the application of appropriate provisioning levels, the tests of the control may include:
- enquiry of the relevant officer and the supervisor/reviewer to ensure they clearly understand the objective of performing the control procedure;
 - examination of the AI's provisioning policies, procedures and methodologies;
 - assessment of whether the process of determining the level of provision has adhered to the policies, procedures and methodologies;
 - examination of the process to obtain the necessary approvals;
 - re-performance of the calculation or carrying out appropriate estimations on the provision amount; and
 - checking that the provision amount has been properly recorded in the books and accounting records of the AI.

Examples of procedures that auditors may have regard to in assessing adequacy of controls are set out in the HKMA's Supervisory Policy Manual IC-3, Annexes A to C.

77. The auditors would also consider carefully the implications of any examinations performed by the HKMA, internal audit of an AI or other parties on an AI's internal control systems or asset quality. A material finding arising from such an examination can be an indicator of potential issues with the control systems in place and which may form the basis of an exception to be reported under section 63(3A).

Correct compilation of returns and information from books and records

78. The auditors' work in testing the compilation process can be viewed or conducted in conjunction with the work done on specific returns under section 63(3). AIs regularly submit information to the HKMA for statistical and prudential supervision purposes. However, the work performed under section 63(3) is, in practice, only limited to a few key returns in a particular period. Consequently, the HKMA is seeking to gain additional comfort on the reliability of the information submitted in other returns throughout the year by way of an examination of the broader return compilation process of an AI.
79. The HKMA has set out in its Supervisory Policy Manual that AIs should have adequate systems of control to enable the submission of reliable statistics and information to it. The auditors are required under section 63(3A)(a)(i) to report on the effectiveness of the systems of control set up to ensure the correct transfer of information from records to returns. The statistics and information would be complete, accurate and prepared in accordance with completion instructions issued by the HKMA. It should be noted that the systems of control would cover not only periodic returns submitted to the HKMA but also other information such as ad hoc surveys and statistics that the HKMA may request from an AI from time to time under section 63(2). The controls expected to be in place and the type of work that could be undertaken to enable auditors to report on the effectiveness of controls would include the following:

a. Controls over data capture for compilation of returns

- AIs have controls in place to ensure that data that is necessary to enable reporting of information to the HKMA is captured completely and accurately. In most circumstances, reporting to the HKMA would be based on a set of predefined criteria and format. As such, it is important that adequate guidance on data definitions and the data capturing process are made available to responsible personnel so that they acquire a proper understanding of the requirements for data capture.
- Auditors would perform procedures to assess whether the relevant officers have an appropriate level of understanding of the reporting requirements taking into account the adequacy of guidance available for the purpose of capturing such information.

b. Understanding of the return compilation process and requirements

- Persons responsible for compilation of returns from the AI's books and records have an adequate understanding of the regulatory requirements and definitions set out by the HKMA in the relevant completion instructions and how they should be applied in the context of the AI's business and operations. The existence of a procedures manual containing an appropriate level of detail provides a source of reference to officers involved to facilitate their understanding of the compilation process and the procedures that are to be carried out in compiling returns and information. Such a procedures manual would set out the timing of reports, compilation procedures, source of information, and other procedures carried out to collect information to ensure complete, accurate and timely compilation of returns and other information. In addition to a procedures manual, guidelines and instructions and relevant correspondence and discussions between the AI and the HKMA which relate to compilation of returns and information would be maintained, filed and made available to responsible officers for reference purposes.
- Auditors would consider the adequacy of the processes and information in place to ensure that this understanding is updated for changes in regulatory reporting requirements as well as changes in business or operations. Auditors would also check the documentation of the control systems, and clarify their understanding of the systems with management to confirm the systems operate in the manner recorded. Auditors are generally expected to perform tests on the effectiveness of these control systems.

c. Maintenance of adequate audit trail

- AIs maintain clear, concise and organized documentation supporting the compilation of returns and other information from the relevant books and records so that there is a clear and traceable link between the underlying records and the completed returns.
- Auditors would carry out procedures to examine such documentation and perform tests to ascertain that information contained in the completed returns and other information are compiled from the underlying books and records and seek appropriate explanations on any material errors or discrepancies thereon from management.

d. Process for clarifying issues

- AIs have in place a process whereby questions and issues (e.g. treatment of particular transactions for reporting purposes) that may arise in the course of compiling returns are identified and resolved in an appropriate manner. Such a process would include escalating the issue to appropriate personnel within the AI and where necessary, referred to the HKMA for clarification. All such clarifications would be properly documented and maintained for future reference purposes.

- Auditors would assess any material issues raised and be satisfied that the manner in which such issues were resolved was appropriate and in accordance with the relevant reporting requirements.

e. Review and approval

- Both the Chief Executive and the Chief Accountant or their equivalents are required to sign off on the returns submitted to the HKMA. The sign-off process is supported by adequate review and approval procedures during the course of the compilation. The purpose of such a review and approval process is to enable errors or inconsistencies to be identified and allow corrections to be made prior to the submission of the information to the HKMA. The review and approval procedures are performed by an officer independent of the preparation process and with an appropriate level of understanding of the requirements and how they are applied to the business and operations of the AI.
- Auditors would appraise the review and approval procedures as well as the experience of those responsible for such reviews and assess the adequacy and effectiveness of these procedures by way of observation, re-performance, or inquiry with relevant personnel.

f. Use of computer-based tools and systems

- AIs commonly make extensive use of computer-based tools and systems in their operations and for maintaining their accounting records. Such AIs place significant reliance on the ability of these systems to ensure that information is captured, processed and reported accurately and completely. The use of computer-based systems to facilitate the compilation of returns and other information from books and records of an AI is also increasingly common.
- Where AIs operate computer-based systems to process information used for compiling returns and other information or rely on such systems to automate the compilation process, the auditors would consider assessing the adequacy of controls over such systems.

g. Backup arrangements

- Staff changes can arise due to various reasons including planned and unplanned leave, rotation of duties, resignations, etc. AIs would have in place procedures to ensure that staff changes do not have any adverse impact on the quality of returns and other information or on the timing of their submission to the HKMA.
- Auditors would understand the AI's backup arrangements and assess whether backup staff responsible for compiling returns and other information have an adequate understanding of the requirements and procedures to be carried out.

Compliance with specific provisions of the Ordinance

80. The guidelines issued by the HKMA require AIs to have effective monitoring and reporting systems to enable compliance with their statutory duties under the Ordinance at all times. While this is a general principle which applies to all duties under the Ordinance, auditors will be asked particularly to report on those controls relevant to the duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII (section 63(3A)(a)(ii)) of the Ordinance. To meet this reporting requirement, auditors would identify whether appropriate control procedures are in place to enable the AI to comply with its statutory duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance and test whether such control procedures are operating effectively.
81. The types of controls that AIs normally have in place to enable compliance with their statutory duties under the Ordinance at all times include:

- Procedures to ensure that management is fully aware of the relevant statutory provisions and regulatory requirements as they apply to the AI's operations;
 - A repository of information containing the Ordinance, guidelines and circulars issued by the HKMA, communications with the HKMA and any amendments to all such documents is maintained, and procedures to ensure effective communication of such information to relevant personnel in the AI;
 - Formal policies on compliance with the provisions of the Ordinance;
 - Procedures on ensuring compliance with statutory and regulatory requirements in all aspects of the AI's operations are maintained. Such procedures may include setting of appropriate limits and targets, monitoring and reporting transactions against limits and targets, stress testing, etc. These procedures would deal not only with day-to-day operations but also the process of introducing new products and businesses;
 - An officer (such as a compliance officer) designated with the responsibility for monitoring and ensuring compliance with statutory and regulatory requirements;
 - Reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant members of management (including the compliance officer) and actions on non-compliance are taken in a timely manner;
 - Procedures for reporting any compliance failure to the HKMA in a timely manner are established;
 - The monitoring of compliance is supported and evidenced by clear, concise and organized documentation to provide an audit trail for subsequent verification.
82. Part XII of the Ordinance deals with the requirements to disclose information to the HKMA, and the auditors' reporting responsibilities in this regard are addressed in their work on examining the AI's control systems for the correct compilation of returns or information from the books and records.
83. A report for the purpose of section 63(3A) also requires auditors to conclude on whether adequate controls are in place to enable compliance with the following provisions of the Ordinance:
- Part XV – Limitations on loans by and interests of AIs
 - Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)
 - Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio
84. The types of controls which are normally in place in the AI to enable compliance with the above provisions and which auditors would take into account in designing their procedures include:
- a. Part XV – Limitations on loans by and interests of AIs*
- Written policy in respect of taking of own shares as security, large exposures and advances to connected parties, shareholdings in other companies and interests in land;
 - Establishment of appropriate internal limits (within the statutory limits under the Ordinance) for individual customers and groups of related customers, shareholdings and interests in land and sub-limits for various business units, branches or subsidiaries;

- Process for identifying and reporting breaches against internal limits to senior management on a continuing basis;
 - Timely reporting of positions and exposures to management to enable appropriate actions to be taken;
 - A system to capture all up-to-date financial exposures to a particular customer or group of related customers, irrespective of whether they are exempted or not;
 - Procedures to ensure that compliance checks are performed prior to approval of facilities;
 - Procedures to enable the terms and conditions for exemptions granted by the HKMA on exempted exposures to be monitored and complied with on an ongoing basis.
- b. Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)*
- Written policy on the AI's strategy on maintaining capital adequacy for the purpose of both its business activities and to meet regulatory requirements;
 - Establishment of target capital ratios which are above the minimum required for business or regulatory purposes;
 - Process for identifying and reporting breaches against target ratios to senior management on a continuing basis;
 - Budgets prepared to take into account capital adequacy requirements and changes in capital adequacy as a result of projected asset mix, balance sheet growth and capital resources;
 - Capital adequacy ratios are calculated and reported to management on an ongoing basis;
 - Procedures on assessing impact of large loans, investments or other significant transactions on capital adequacy prior to the transaction taking place;
 - Stress-tests are performed on capital adequacy ratio on a regular basis.
- c. Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio*
- Written policy on the AI's strategy and procedures for maintaining adequate liquidity at all times to meet business and regulatory requirements;
 - Target ratios for liquidity and maturity mismatch (if any) which are above the minimum regulatory requirements are set and procedures are in place to identify and immediately report breaches or exceptions to senior management;
 - Procedures are in place to allow liquidity and maturity mismatch ratios to be reported and monitored on an ongoing basis;
 - Procedures on assessing impact of large loans, investments or other significant transactions on liquidity prior to the transaction taking place;
 - Contingency plans are in place for coping with various types of liquidity crisis;
 - Stress-tests are performed on the liquidity position on a regular basis.

85. A checklist of questions concerning compliance with Part XII, XV, XVII or XVIII of the Ordinance is set out in Appendix 7 to this PN.
86. Other procedures that auditors may consider in assessing controls to ensure compliance with Parts XV, XVII and XVIII are set out in the HKMA's Supervisory Policy Manual IC-3, Annex B.

Maintenance of adequate provision

87. For locally incorporated AIs only, auditors are required to report on whether or not, during the period, the AI had in place systems of control which were adequate to enable it, as much as is practicable, to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur, and if those systems were not adequate the nature and extent of those inadequacies.
88. Maintenance of adequate provision is one of the key criteria for maintaining an authorization and for many AIs, an area of particular focus by management. The HKMA has also issued guidelines on loan classification and provisioning requiring AIs to have adequate policies and procedures for the regular appraisal of the quality of their assets and for the establishment of adequate provision for bad and doubtful debts.
89. Auditors, as part of the statutory audit may have performed certain procedures relating to the maintenance of adequate provision and the work required to comply with their statutory reporting duties under this section may be an extension of the work performed for statutory audit purposes.
90. The types of controls AIs would normally maintain to ensure that they meet the objective of maintaining adequate provision include:
 - Written policies and procedures setting out the frequency of review, methodology and level of provision to be maintained for each class of exposure (e.g. on- and off-balance sheet);
 - An appropriate loan classification system with clear definitions (both qualitative and quantitative measures) for each class of exposures to allow monitoring of asset quality on a regular basis;
 - Minimum provision levels are set and observed for each class in the classification system;
 - Responsibilities for reviewing and approving provision are clearly allocated to officers or committees with sufficient authority;
 - The credit process includes procedures for:
 - monitoring of asset quality and concentration risks by country and sector;
 - monitoring of adverse economic or political factors which may have an effect on asset quality or borrowers' repayment ability;
 - monitoring of overdue, rescheduled or over-limit assets;
 - reviewing irregularities in individual credit exposures;
 - reviewing the borrowers' and guarantors' financial position;
 - reviewing and updating the value of collateral on a regular basis; and
 - suspending or ceasing interest accrual for non-performing assets.
 - Procedures are carried out to review and assess the level of provision on a regular basis;
 - Provisioning decisions are recorded, documented and reported to senior management, an appropriate committee and to the Board on a regular basis;
 - Procedures are carried out to review the value of assets on a regular basis (such as fixed assets, investments and other assets) to assess whether impairment or loss exists;

- Procedures are in place to identify and determine an appropriate level of provision for liabilities including assessments of whether contingent liabilities should be recognized as liabilities on the balance sheet (e.g. litigation cases).

Representations by management

91. Auditors would follow the guidance in SAS 440, “Representations by Management” or HKSA 580, “Management Representations” when it is finalized and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management’s responsibility for establishing and maintaining the systems of internal control and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that management has disclosed to the auditors all material weaknesses in the internal control systems of which it is aware and also those areas for which management believes the cost of corrective action may exceed the benefits;
 - c. stating that management has made available to the auditors all relevant information (e.g. records and documents, procedures manuals, instructions and correspondence with the HKMA, etc.) for the purpose of the auditors’ examination of the internal control systems;
 - d. describing any irregularities involving management or employees who have significant roles in the systems of internal control;
 - e. stating whether there were any changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses;
 - f. stating whether there have been communications between regulatory authorities and the AI concerning non-compliances with or deficiencies in internal control systems and procedures and reporting practices which would have a material effect on the returns;
 - g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period;
 - h. for locally incorporated AIs only, confirming that the AI has maintained adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses during the relevant period;
 - i. for registered institutions, confirming that the AI has complied with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (see paragraphs 129 to 137);
 - j. confirming that management is not aware of any matters which would adversely affect the financial position of the AI to a material extent; and
 - k. management has read the draft auditors’ report and confirms the factual accuracy of information and statements contained in the draft auditors’ report.
92. An example management representation letter is set out in Appendix 2 to this PN – Example 2.

Materiality

93. An exception which would be reported for the purpose of a report under section 63(3A) would relate to either:

- a material weakness in controls over (i) compilation of returns and other information, (ii) compliance with certain provisions of the Ordinance, and (iii) maintenance of adequate provision;
 - an actual contravention of the Ordinance; or
 - inadequate provision.
94. Auditors would exercise judgment on whether a weakness or failure in the control systems is material taking into account the impact such a weakness or failure may have on the quality of the reported information, the ability of the AI to comply with relevant provisions of the Ordinance and to maintain adequate provision. In respect of an overseas incorporated AI, it is a weakness or failure in the control systems which is material in the context of the AI's operations in Hong Kong which would be reported.
95. Considerations on materiality in the context of reporting under section 63(3A) are wide ranging and vary depending on the nature, size and complexity of the AI concerned. Whilst an actual contravention of the Ordinance is generally a factual matter, what is considered to be material for the purpose of reporting on controls and adequacy of provision requires the exercise of judgment in the context of the AI concerned. Auditors would perform adequate procedures to confirm existence and effectiveness of controls on areas which, in their judgment, are material with respect to the AI.
96. The auditors would normally be required to report separately under section 63(3) on whether specific returns were compiled based on the AI's books and records. Errors or exceptions (whether material or not) identified in the course of the auditors' work for the purpose of section 63(3) are prima facie evidence that there may be an internal control weakness in the compilation process. Therefore, auditors would consider carefully the underlying reasons leading to such errors and assess their implications on the work under section 63(3A).
97. When evaluating the manner in which a specific finding should be reported, the auditors would take into account the requirements of Supervisory Policy Manual and guidelines issued by the HKMA and any potential impact on the AI's financial position.

Reporting

98. The auditors' report under section 63(3A) is a report on both the existence of appropriate controls and whether such controls have operated effectively during the specified period. The opinion in the auditors' report under section 63(3A) is structured into two main parts. The first part is an opinion for the purpose of section 63(3A)(a) on whether controls are in place to enable:
- the AI to correctly compile from its books and records, in all material respects, the returns and other information, which are required to be submitted to the HKMA;
 - the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance; and
 - the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur (for locally incorporated AIs only).
- The second part is an opinion for the purpose of section 63(3A)(b) given on the basis of the work performed under section 63(3A)(a), on whether the auditors were aware of:
- any instances where the AI has materially contravened any of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance; and

- for locally incorporated AIs, any instances where the AI has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
99. The opinion in respect of section 63(3A)(b) is drawn from the work performed under section 63(3A)(a). However, the HKMA would expect auditors to take into account any other information which comes to their attention in their capacity as auditors of the AI, including any information obtained from the normal course of any audit work performed and in the auditors' examination of specific returns under section 63(3).
100. An appropriate description of any weakness or failure in the control systems considered to be material would be reported together with the auditors' recommendations for improvement where possible.
101. The auditors' report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. As an assurance engagement, the report issued by auditors would comply with the requirements set out in HKSAE 3000 and a statement that the engagement was conducted in accordance with HKSAE 3000 would be included in the auditors' report. The auditors' report would be completed, dated and submitted to the AI. Normally, the report by the auditors has to be submitted to the AI within three months from the end of the specified period and the AI would forward the auditors' report together with any comments thereon within a further one month.
102. Examples of auditors' reports under section 63(3A) are set out in Appendix 1 to this PN – Examples 3 and 4.

Ad hoc reports under section 59(2)

General

103. The HKMA has discretionary power under section 59(2) to require an AI, after consultation with the AI, to provide an auditors' report on any matters the HKMA may specify which are relevant for the exercise of its functions. This power enables the HKMA to require an AI to appoint auditors to report on internal controls, specific transactions, or any other matters which are relevant for the performance of its functions under the Ordinance.
104. A report under section 59(2) is commissioned on an ad hoc basis. The circumstances which can lead to a decision by the HKMA to commission such a report generally relate to the identification of issues or events which pose a significant adverse risk to the AI's financial position, business or operations, or represent a threat to the interest of depositors or stability of the banking sector. Such issues or events can arise from:
- significant internal control weaknesses raised in management letters from the AI's auditors;
 - issues arising from reviews by the HKMA or internal auditors;
 - frequent errors in returns submitted to the HKMA;
 - occurrence of an adverse event (e.g. fraud) affecting the AI;
 - significant exposures to certain high risk business activities.
105. As set out in the HKMA's Supervisory Policy Manual IC-3, the HKMA can also require a report to be commissioned on the financial affairs of the AI, based on an audit of its financial statements, if the HKMA has reason to believe that the normal audit carried out by the auditors was, or is likely to be, deficient.

106. The AI's statutory auditors may be appointed for the purposes of reporting under section 59(2). Even where there are no doubts about the capability of the statutory auditors, the HKMA has the right to require that a report under section 59(2) be obtained from another firm of auditors to obtain a fresh perspective on matters which are the subject of the report.
107. The extent of the detail included in the auditors' report concerning the description of the relevant internal controls and of the procedures undertaken to test the operation of those controls to support the conclusion provided is a matter of judgment for the auditors. The auditors would have regard to the expectations of the HKMA and the AI and would evaluate the risk of misinterpretation or misunderstanding in this regard.
108. The auditors would seek to ensure that the extent of the description of the relevant internal controls to be included in the report and the extent of the procedures to be undertaken is specified in the Letter of Instruction issued by the AI. Similar principles apply to any other engagement requiring the exercise of significant judgment.

Scope

109. Due to the fact that a section 59(2) report is commissioned on an ad hoc basis, the HKMA would consult with the AI and the auditors on the scope of work and agree in advance on the terms of reference prior to issuing a notification in writing to the AI requiring such a report.
110. During the discussion with the HKMA and the AI regarding the scope to be covered in the ad hoc review, the following factors would be taken into account:
- Exact scope (including any specific concern) that the HKMA would like to be covered in the ad hoc review;
 - Agreed assurance and materiality level;
 - Specific areas of concern that the HKMA would like the auditors to cover in the ad hoc review;
 - Specific guidelines on format of deliverables, including level of assurance required from the auditors.
111. The period to be covered by a report under section 59(2) will vary depending on the circumstances, but the HKMA has indicated that it will not normally exceed 12 months. Factors to be taken into consideration in determining the period to be covered include whether:
- there is enough evidence of policies, controls and records available in the period (for example, whether relevant senior management meetings will have taken place); or
 - changes are expected in the area(s) to be examined (for example in systems, processes, management or products). If so, the auditors would determine whether the auditors' report is intended to reflect the position before, after or during the change period.
112. In certain circumstances, the auditors might be unable to assess the proposed scope sufficiently without a greater understanding of the AI's operations in the area to be examined – for example the organizational structure, product profiles or volumes of transactions. This can arise where the auditors are not the AI's statutory auditors or the scope relates to an area that is not covered extensively by statutory audit work. In these circumstances, the auditors may wish to agree with the HKMA and the AI that a short initial visit to the AI be undertaken before the final scope of the work is agreed. This would enable the auditors to assist the HKMA in refining the scope more effectively.
113. Where applicable, the auditors would agree with the HKMA and the AI on which of the AI's legal entities, divisions, or businesses the report would cover.

114. The auditors' report would normally be submitted to the AI within a period of three months from the date of the notification letter issued by the HKMA and forwarded to the HKMA together with comments from the AI within a further month. The reporting deadline can be varied at the discretion of the HKMA to take into account special circumstances after consultation with the AI and the auditors concerned.

Nature of work

115. The work that auditors perform for the purpose of reporting under section 59(2) would vary depending on the circumstances surrounding the commissioning of such a report and the subject matter. As such, the engagement can be a reasonable or limited assurance engagement or an engagement to perform agreed-upon procedures.
116. For assurance engagements, auditors would seek to develop and establish suitable criteria for the engagement based on specified modules of Supervisory Policy Manual or guidelines issued by the HKMA. The modules of Supervisory Policy Manual or guidelines issued by the HKMA used would be agreed in advance. The determination of whether the engagement provides reasonable assurance or limited assurance would depend on the level of assurance required in the circumstances of the engagement. For engagements that fall outside the framework for assurance engagements, they would be considered as agreed-upon procedures engagements.
117. Reference would be made to HKSAE 3000 and HKSRS 4400, "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" for details on the standards and guidance in this regard.

Materiality

118. Given the varying nature of ad hoc reviews under section 59(2), the auditors would ensure that clear reference points have been agreed with both the AI and the HKMA to determine the level of assurance that can be provided under given terms of reference. For some engagements, the terms of reference can be expressed in terms of one or more HKMA's and / or other requirements. Some terms of reference are highly specific, quantitative and objective and therefore readily capable of reliable and consistent measurement and interpretation. Some terms of reference are general, qualitative and highly subjective. Others may fall between these two extremes.
119. In order to assess fully the level of assurance that is appropriate concerning general, qualitative, subjective terms of reference, the auditors, where necessary, would assist the HKMA and the AI to prepare, a set of specifically developed criteria which are more capable of reliable and consistent measurement and interpretation in light of the requirements of the HKMA. In many cases, reference can be made to Supervisory Policy Manual and guidelines issued by the HKMA and other pronouncements which set out in sufficient detail the assessment criteria to support an assurance engagement. However, the HKMA remains responsible for determining whether the specifically developed criteria meet its purposes for commissioning a report.

Reporting

120. The auditors would consider whether it is necessary to provide in the report an introductory or background section to set in context the conclusion (or overall findings otherwise reported).
121. Such background information is relevant to the area examined in the report and can include, for example, a description of the organization in that area, the main business lines, the profile of the business and the market significance in the sector and the description of the procedures undertaken.
122. Detailed narrative reports are normally necessary in order to communicate properly the judgments made, the reasons underpinning those judgments and the context in which a

conclusion is provided. The implications for the auditors are that a report covering internal controls includes, inter alia, comparatively detailed descriptions of:

- the elements of the design and operation (as applicable) of the internal control systems that are subject to evaluation; and
 - the extent and nature of the procedures undertaken to gain assurance that the internal controls specified operate as prescribed (if part of the scope).
123. The description of the procedures undertaken includes, where appropriate, such matters as details of documents examined, persons interviewed and tests of detail performed.
124. Auditors would attach a copy of the engagement letter and the Letter of Instruction from the AI as appendices to the auditors' report.
125. An example of a report under section 59(2) is set out in Appendix 1 to this PN – Example 5.

Notification of audit qualifications or adverse statements under section 59A(2)(c)

126. Under section 59A(2)(c), auditors of an AI appointed under section 131 of the Companies Ordinance are required to provide written notice to the HKMA if they decide to include in their audit report on the AI's financial statements any qualification or adverse statement as to a matter mentioned in section 141 of the Companies Ordinance.
127. The issue of a qualified audit report or an adverse statement in relation to a matter under section 141 of the Companies Ordinance may have a potentially significant impact on the AI concerned and have to be communicated to the HKMA as soon as reasonably practicable. Except for matters required to be reported under sections 63A and 63B, auditors would normally be expected to discuss with the AI any matter about which they are concerned, and request that the AI draws the matter to the attention of the HKMA. Nevertheless, it is important for auditors to strike a balance between preserving their professional relationship with the AI, the possible impact on depositors' interests arising from a delay in reporting and the need to take appropriate legal advice in deciding whether to report such an issue via the AI or directly to the HKMA. In relation to a qualification or an adverse statement, the auditors would take into account the severity of the matter as well as the AI's response to the auditors' request to communicate the matter to the HKMA.
128. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has set out examples of the circumstances where it believes management of the AI should not be informed in advance in the interest of protecting depositors and the auditors should report directly to the HKMA after considering appropriate independent legal advice. Auditors would make reference to these examples in assessing the circumstances surrounding their qualification of the audit report on an AI's financial statements or an adverse statement in connection with a matter under section 141 of the Companies Ordinance.

Reporting of significant adverse matters and non-compliances under sections 63A and 63B

129. Sections 63A and 63B require AI's auditors to submit a report to the HKMA if 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 (section 63A); or
 - Constitutes on the part of an AI that is a registered institution under the Securities and Futures Ordinance ("SFO") a failure to comply with certain provisions or rules made under the SFO (section 63B).

130. Matters which are required to be reported under sections 63A and 63B have to be reported by the auditors in writing directly to the HKMA as soon as is reasonably practicable. There is no specified format for such a report but the report would cover the nature of the matter and the reasons why the auditors are of the opinion that the matter should be reported.
131. Section 63A requires auditors which are appointed under section 59(2), 63(3) or 63(3A) of the Ordinance or section 131 of the Companies Ordinance to report to the HKMA if they become aware of a matter which, in their opinion, adversely affects the financial position of an AI to a material extent. Auditors would consider any such matter which comes to their attention in the context of the AI as a whole. In relation to an overseas incorporated AI, the requirement of section 63A applies to its principal place of business in Hong Kong and its local branches and as if the principal place of business in Hong Kong and those branches were collectively a separate AI.
132. Some of the matters which the HKMA would expect to be reported under section 63A include the following:
- 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;
 - whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.
133. As matters which are reportable under section 63A relate to the financial position of AIs, auditors are expected to take into consideration potential issues that may constitute a reportable matter under this section in the course of performing their work on AI's financial statements or for the purpose of reporting under section 59(2), 63(3) or 63(3A).
134. Under section 63B, when auditors become aware of a matter that, in their opinion, is a matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the SFO (a "reportable matter"), they shall, as soon as practicable after they become aware of the matter, submit to the HKMA a report in writing on the matter.
135. A reportable matter in respect of AIs refers to a matter that, in the auditors' opinion constitutes on the part of the AI a failure to comply with any prescribed requirement. Prescribed requirement refers to the requirements of any rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO. However, it should be noted that section 63B specifically excludes the requirements under section 149 of SFO in relation to holding of client monies.
136. The HKMA has recognized that there is no obligation for the auditors to specifically perform work or to change the scope, nature and depth of their work to identify non-compliance with the requirements of the SFO where such work does not already form part of the procedures carried out for the purpose of an audit on the AI's financial statements, or for the purpose of reporting under section 59(2), 63(3) or 63(3A). Therefore auditors are not required to actively seek out grounds for making a report under section 63B and it is only when they become aware, in the ordinary course of their work, of a reportable matter that they would make a report to the HKMA.
137. A summary of the relevant regulations and requirements issued by the SFC that auditors would have to be familiar with for the purpose understanding and fulfilling their duties under section 63B is set out in Appendix 6 to this PN.

Notification of resignation of auditors under section 59A(2)

138. Section 59A(2) requires auditors of AIs appointed under section 131 of the Companies Ordinance to provide written notice to the HKMA if they resign before the expiration of their term of office (section 59A(2)(a)) or if they do not seek to be re-appointed (section 59A(2)(b)). Such a written notice is required to be provided to the HKMA immediately.

Report of factual findings in relation to voluntary revocation of authorization

139. In an application for voluntary revocation of the authorization of an AI, the HKMA would require the AI to furnish a report by its auditors in respect of the balance sheet, third party deposit liabilities, contingent liabilities and outstanding commitments. This report would help satisfy the HKMA that the interests of the AI's depositors are or will be adequately safeguarded when the AI's authorization is revoked. The HKMA may provide a copy of the report to the Financial Secretary of the Hong Kong Special Administrative Region Government for the purpose of section 22(1).
140. A report by auditors of factual findings in relation to a voluntary revocation of the authorization of an AI is an agreed-upon procedures engagement. As the auditors simply provide a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditors and draw their own conclusions from the auditors' work. Reference would be made to HKSRS 4400 for details on the standards and guidance in this regard. An example engagement letter for a report of factual findings in relation to voluntary revocation of authorization is set out in Appendix 3 to this PN – Example 3.
141. The report of factual findings by auditors is prepared based on specified procedures which would include the following matters:
- a. Whether the AI had any outstanding third party deposit liabilities according to the general ledger and customers deposit records of the AI as at a specified date, and whether this is consistent with the information in the board minutes and the management representation letter;
 - b. Whether the balance sheet as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the board minutes and the management representation letter; and
 - c. Whether the summary of contingent liabilities and outstanding commitments as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the board minutes and the management representation letter.
142. Auditors would follow the guidance in SAS 440, "Representations by Management" or HKSA 580, "Management Representations" when it is finalized, and obtain a letter of representation from management covering, inter alia, the following areas as at the specified date for the purpose of the report:
- a. there were no third party deposit liabilities outstanding in the books of the AI;
 - b. the balance sheet was in agreement with the AI's books and records; and
 - c. the summary of contingent liabilities and outstanding commitments was in agreement with the AI's books and records.
143. An example management representation letter is set out in Appendix 2 to this PN – Example 3.

144. The report of factual findings is prepared in accordance with HKSRS 4400. A copy of the balance sheet of the AI and a summary of contingent liabilities and outstanding commitments (or a nil report if there are no contingent liabilities and outstanding commitments) as at the specified date would be attached to the report. An example of the report is set out in Appendix 1 to this PN – Example 6.

PART III – PROTECTION FOR AUDITORS ON COMMUNICATIONS WITH THE HKMA

145. Section 61 permits auditors, notwithstanding any duty which they may owe to their clients (e.g. confidentiality), to communicate to the HKMA, provided that:
- the communication, whether or not in response to a request by the HKMA, 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 HKMA under the Ordinance.
146. The protection covers not only auditors appointed under section 131 of the Companies Ordinance but also auditors appointed for the purpose of sections 50(1)(c), 59(2), 63(3) and 63(3A). It also covers auditors who make a report to the HKMA under sections 63A and 63B.
147. The protection afforded by section 61 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 HKMA notwithstanding that:
- the information does not relate to the auditing work undertaken by them; or
 - the source of the information was not the AI.
148. Section 61 does not of itself require auditors to change the scope, nature and depth of their audit work and they are not required to actively seek out grounds for making a report under this section.
149. Appendix 4 to this PN contains further guidance on ad hoc reports under section 61 that has been prepared to assist auditors in understanding the circumstances in which they would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61. Section 61 does not lay down any rules nor specify the circumstances in which the auditors are to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditors may make matters known to the HKMA without breaching their duty of confidentiality.

APPENDIX 1 Examples of reports by auditors

Example 1 – Section 63(3) report for locally incorporated AIs

SECTION 63(3) REPORT BY THE AUDITORS TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Return of Capital Adequacy Ratio of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* as at [*date*];
- ii. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*];
- iii. Part I of the Return of Liquidity Position of the [*Institution and all its subsidiaries*]* [*Institution and certain of its subsidiaries set out below*]* [*Institution and its subsidiaries other than those set out below*]* [*Institution on a consolidated basis*]* [*Institution’s offices in Hong Kong*]* for the month of [*month/year*]; and
- iv. Parts I - III of the Certificate of Compliance of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*].

[The subsidiaries referred to in i., ii., iii. and iv. above are as follows:]*

Respective responsibilities of the directors and auditors

As the directors of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us. These procedures do not represent an audit of the books and records of the Institution.

Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000, “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830, “Reports by Auditors Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Use of this report

This report is for submission to the Monetary Authority by the Institution pursuant to section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

* Delete where not applicable

Example 2 – Section 63(3) report for local branch(es) of overseas incorporated AIs

SECTION 63(3) REPORT BY THE AUDITORS TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank’s Hong Kong Branch(es) (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution for the quarter ended [date];
- ii. Part I of the Return of Liquidity Position of the Institution for the month of [month/year]; and
- iii. The Certificate of Compliance of the Institution for the quarter ended [date].

Respective responsibilities of the chief executive and auditors

As the chief executive of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us. These procedures do not represent an audit of the books and records of the Institution.

Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000, “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830, “Reports by Auditors Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Use of this report

This report is for submission to the Monetary Authority by the Institution pursuant to section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

Example 3 – Section 63(3A) report for locally incorporated AIs

SECTION 63(3A) REPORT BY THE AUDITORS TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period:

- i. there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- ii. it appears that the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Respective responsibilities of the directors and auditors

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000, “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830, “Reports by Auditors Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period,
 - i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

This report is for submission to the Monetary Authority by the Institution pursuant to section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. *The situation where the auditors have no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*

- ii. The situation where the auditors have some reservation(s) about the institution's systems of internal control but have formed the view, on the basis of the evidence which they have seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*
- iii. The situation where the auditors have severe reservations about the institution's systems of internal control, and have formed the view, on the basis of the evidence which they have seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

Example 4 – Section 63(3A) report for local branch(es) of overseas incorporated AIs

SECTION 63(3A) REPORT BY THE AUDITORS TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank’s Hong Kong Branch(es) (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period, there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV and XVIII of the Ordinance.

Respective responsibilities of the chief executive and auditors

As the chief executive of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance.

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000, “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830, “Reports by Auditors Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

This report is for submission to the Monetary Authority by the Institution pursuant to section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. The situation where the auditors have no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*
- ii. The situation where the auditors have some reservation(s) about the institution's systems of internal control but have formed the view, on the basis of the evidence which they have seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*
- iii. The situation where the auditors have severe reservations about the institution's systems of internal control, and have formed the view, on the basis of the evidence which they have seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

Example 5 – Section 59(2) report

It should be noted that the scope and content of a report under section 59(2) would vary depending on the purpose and requirements of the HKMA in commissioning such a report. The example below focuses on a review of internal control systems and is only intended to provide an illustration of how such a review report could be structured and presented but other forms of presentation may be appropriate subject to discussion and agreement with the AI and the Monetary Authority. The precise details of the report should be suitably modified to suit individual circumstances.

**SECTION 59(2) REVIEW REPORT
XYZ BANK**

In accordance with our engagement letter dated [date] (“Engagement Letter”), a copy of which is attached as Appendix [] to this report, we have carried out a review under section 59(2) of the Banking Ordinance (the “Ordinance”) in relation to matters specified in the Letter of Instruction issued by XYZ Bank (the “Institution”) dated [date].

Scope

The scope of our examination is set out in the Letter of Instruction which requires:

1. a review of the internal control systems of the Institution which were in existence during the period from [date] to [date] (the “review period”) against the requirements set out in the following modules of Supervisory Policy Manual (“SPM”), guidelines and circulars issued by the Monetary Authority:

[list of all relevant modules of SPM, guidelines and circulars issued by the Monetary Authority]

2. *[set out other specified areas of review as appropriate]**

Respective responsibilities of the directors and auditors

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems which comply with the requirements of the Ordinance, and SPM, guidelines and circulars issued by the Monetary Authority. In fulfilling that responsibility, estimates and judgment must be made to assess the expected benefits and related costs of management information and of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that banking risks are properly monitored and evaluated and that transactions are executed in accordance with established authorization procedures and are recorded properly, to enable you to conduct the business in a prudent manner.

It is our responsibility to conduct an independent review in accordance with the Engagement Letter addressing the scope set out in the Letter of Instruction and report on:

- a. whether we are aware of any matters which may indicate that the Institution has not established and maintained controls in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority;
- b. *[set out responsibilities for other specified areas of review as appropriate]**; and
- c. our findings and recommendations in relation to the above

based on the results of the procedures performed by us.

Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000, “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830, “Reports by Auditors Under the Banking Ordinance” (“PN

830”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) for the purpose of reporting on whether relevant internal control systems of the Institution were established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority.

In respect of [*other specified areas of review*], our engagement was conducted in accordance with [*Hong Kong Standard on Assurance Engagements 3000*]* [*Hong Kong Standard on Related Services 4400 “Engagements to Perform Agreed-Upon Procedures Regarding Financial Information”*]* and with reference to PN 830 issued by the HKICPA.

We have performed such procedures [*as we considered necessary for the purpose of reporting in accordance with the above requirements*]* [*as were agreed and set out in the Engagement Letter*]*.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Findings and recommendations

The findings and recommendations arising from our review of the internal control systems are set out in section [] of the Findings and Recommendations Report (Appendix [] to this report). Details of the findings and recommendations in relation to [*other specified areas of review*] are set out in section [] of the Findings and Recommendations Report.

Conclusion

Based on the foregoing, with the exception of the matters set out in the Findings and Recommendations Report:

1. having regard to the nature and scale of the business of the Institution, during the review period, nothing has come to our attention that causes us to believe that the Institution’s internal control systems were not established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and
2. [*conclude on other specified areas of review as appropriate*].

Use of this report

This report is for the information of the Institution and its Board of Directors in dealing with the matters set out in the Letter of Instruction dated [*date*] and for submission to the Monetary Authority. This report is not intended to be, and should not be, distributed to any other party or used by anyone for any other purpose.

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [*Date*]

* *Delete where not appropriate*

Example 6 – Report of factual findings in relation to voluntary revocation of authorization**REPORT OF FACTUAL FINDINGS IN RELATION TO XYZ’S APPLICATION FOR VOLUNTARY REVOCATION OF ITS AUTHORIZATION AS A [DEPOSIT-TAKING COMPANY / RESTRICTED LICENCE BANK / BANK]***

In accordance with your Letter of Instruction dated [date], a copy of which is attached, we have performed the procedures below with respect to XYZ (the “Institution”). Our engagement was conducted in accordance with Hong Kong Standard on Related Services 4400, “Engagements to Perform Agreed-Upon Procedures Regarding Financial Information” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”). The procedures were performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution’s application for voluntary revocation of authorization as a [deposit-taking company / restricted licence bank / bank]*. The procedures are summarized as follows:

1. We inspected the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [date].
2. We obtained the attached balance sheet as at [date] which was prepared by the management of the Institution, and compared it to the books and records.
3. We obtained the attached summary of contingent liabilities and outstanding commitments as at [date] which was prepared by the management of the Institution, and compared it to the books and records.
4. With respect to (1) – (3) above, we also:
 - a. obtained and reviewed the minutes of the Board of Directors for the period from [date] to [date] (“Board Minutes”); and
 - b. obtained a representation letter from the Board of Directors (“Representation Letter”).

We report our findings as follows:

- a. With respect to item 1, we found there were no third party deposit liabilities outstanding in the books of the Institution as at [date], and this was consistent with the information in the Board Minutes and the Representation Letter.
- b. With respect to item 2, we found the attached balance sheet as at [date] was in agreement with the Institution’s books and records, and was consistent with the information in the Board Minutes and the Representation Letter.
- c. With respect to item 3, we found the attached summary of contingent liabilities and outstanding commitments as at [date] was in agreement with the Institution’s books and records, and was consistent with the information in the Board Minutes and the Representation Letter.

Because the above procedures do not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, we do not express any assurance on the Institution’s balance sheet, third party deposit liabilities, contingent liabilities and commitments as at [date].

Had we performed additional procedures or had we performed an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report. It relates only to the items specified above and does not extend to any financial statements of the Institution, taken as a whole.

This report is intended for filing with the Monetary Authority. We have no objection that a copy of this report is given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, this report should not be used for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

** Delete where not appropriate*

APPENDIX 2

Examples of management representation letters

The following specimen letters are for reference only and will need to be modified according to the requirements and circumstances of individual AIs.

Example 1 – Management representation letter for reporting under section 63(3)

[Client's letterhead]

[Audit Firm]

[Address]

[Date of Auditors' report]

Dear Sirs

In connection with your engagement pursuant to the requirements of section 63(3) of the Banking Ordinance to report on the following returns ("the Returns"):

- i) the [*consolidated*]* Return of Capital Adequacy Ratio of the [*Bank / Company*] as at [*date*]; [*applicable to locally incorporated AIs only*]
- ii) Parts I, II, and III of the [*consolidated*]* Return of Large Exposures of the [*Bank / Company / Branch*]* for the quarter ended [*date*];
- iii) Part I of the [*consolidated*]* Return of Liquidity Position of the [*Bank / Company / Branch*]* for the month of [*month/year*]; and
- iv) the [*consolidated*]* Certificate of Compliance of the [*Bank / Company / Branch*]* for the quarter ended [*date*],

we confirm to the best of our knowledge and belief, and having made appropriate enquiries of other [*directors and*]* officials of the [*Bank / Company / Branch*]*, the following representations made to you during your engagement:

1. We acknowledge our responsibility for establishing and maintaining adequate accounting records and systems of control to ensure that the Returns have been correctly compiled from the books and records of the [*Bank / Company / Branch*]*, and that the [*Bank / Company / Branch*]* complies with the provisions of the Banking Ordinance at all times.
2. We confirm that all transactions undertaken by the [*Bank / Company / Branch*]* have been properly reflected and recorded in the accounting records.
3. We acknowledge that all of the following information has been made available to you for the purposes of performing your procedures on the Returns:
 - i) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments (including derivative transactions and credit arrangements) of the [*Bank / Company / Branch*]*;
 - ii) All procedures manuals for the preparation of the Returns and compliance with the Banking Ordinance;
 - iii) Policies and procedures manuals for the key operating areas of the [*Bank / Company / Branch*]*;
 - iv) All instructions, correspondence and minutes or notes of meetings with the Monetary Authority;

- v) Identities of all connected parties for the purpose of Part I of the Return of Large Exposures; and
 - vi) Other information which may be relevant to the preparation of the Returns.
4. We confirm that there have been no contraventions by the *[Bank / Company / Branch]** of any of its duties under Part XII, XV, *[XVII]* [applicable to locally incorporated AIs only]* or XVIII of the Banking Ordinance during the period from *[date]* to *[date]* or which were the subject of correspondence during this period.
 5. We confirm that all communications between the *[Bank / Company / Branch]** and the Monetary Authority and other regulatory authorities concerning non-compliance with or deficiencies in financial reporting practices which could have a material effect on the information presented in the Returns have been disclosed to you.
 6. We are not aware of any matter which adversely affects the financial position of the *[Bank / Company / Branch]** to a material extent.
 7. *[For registered institutions only]* We are not aware of any matter that constitutes on the part of the *[Bank / Company / Branch]** a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
 8. We confirm that we have read the draft auditors' report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

Yours faithfully

[For and on behalf of.....]

Director*/Chief Executive*

Chief Accountant

* *Delete where not appropriate*

Example 2 – Management representation letter for reporting under section 63(3A)

[Client's letterhead]

[Audit Firm]

[Address]

[Date of Auditors' report]

Dear Sirs

In connection with your engagement pursuant to the requirements of section 63(3A) of the Banking Ordinance for the examination of our internal control systems to enable:

- i) the returns or information of the *[Bank / Company / Branch]** submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the *[Bank / Company / Branch]**;
- ii) the *[Bank / Company / Branch]** to comply with its duties under Parts XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* and XVIII of the Banking Ordinance; and
- iii) the *[Bank / Company / Branch]** to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur *[applicable to locally incorporated AIs only]*

for the period/year ended *[date]*, we confirm to the best of our knowledge and belief, and having made appropriate enquiries of other *[directors and]** officials of the *[Bank / Company / Branch]**, the following representations made to you during your examination:

1. We acknowledge our responsibility for establishing and maintaining adequate internal control systems.
2. We acknowledge that all of the following information has been made available to you for the purposes of performing your procedures on the relevant internal control systems:
 - i) Written procedures regarding the preparation of banking returns and compliance with the Banking Ordinance;
 - ii) All instructions and correspondence with the Monetary Authority;
 - iii) All accounting records; and
 - iv) Any other necessary information.
3. We are not aware of any violations or possible violations of the Companies Ordinance, the Banking Ordinance or any other regulations the effect of which should be considered for disclosure or as a basis for a provision.
4. We confirm that there have been no contraventions by the *[Bank / Company / Branch]** of any of its duties under Part XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* or XVIII of the Banking Ordinance during the period from *[date]* to *[date]*.
5. There have been no communications between regulatory authorities and the *[Bank / Company / Branch]** concerning non-compliance with or deficiencies in financial reporting practices which could have a material effect on the banking returns.
6. The *[Bank / Company]** has maintained adequate provision during the period from *[date]* to *[date]* *[applicable to locally incorporated AIs only]*.

7. We are not aware of any matter which adversely affects the financial position of the [*Bank / Company / Branch*]* to a material extent.
8. [*For registered institutions only*] We are not aware of any matter that constitutes on the part of the [*Bank / Company / Branch*]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
9. We confirm that we have read the draft auditors' report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

Yours faithfully

[*For and on behalf of*]

Director*/Chief Executive*

Chief Accountant

* *Delete where not applicable*

**Example 3 – Management representation letter for report of factual findings
in relation to voluntary revocation of authorization**

[Client's letterhead]

*[Audit Firm]
[Address]*

[Date of report]

Dear Sirs

We confirm to the best of our knowledge and belief, and having made appropriate enquiries of other *[directors and]** officials of the *[Bank / Company / Branch]**, the following representations made to you in connection with your performance of the agreed-upon procedures in respect of the voluntary revocation of the authorization of the *[Bank / Company / Branch]**:

1. We acknowledge our responsibility for establishing and maintaining adequate accounting records and systems of control to ensure that the financial statements of the *[Bank / Company / Branch]** for the period from *[date]* to *[date]* have been properly prepared from the books and records of the *[Bank / Company / Branch]**.
2. We confirm that all transactions undertaken by the *[Bank / Company / Branch]** have been properly reflected and recorded in the accounting records.
3. We confirm the following:
 - (a) As at *[date]*, the *[Bank / Company / Branch]** had no third party deposit liabilities outstanding;
 - (b) As at *[date]*, the *[Bank / Company / Branch]** 's balance sheet agrees with the accounting records made available to you. The *[Bank / Company / Branch]** has maintained adequate provision for its liabilities and commitments as at *[date]*; and
 - (c) As at *[date]*, we are not aware of any outstanding business commitments, contingent liabilities or other outstanding commitments which have not been wound down or properly honoured or transferred by mutually satisfactory arrangements except for those stated in the summary of contingent liabilities and outstanding commitments as at *[date]* and disclosed in the attachment to your report.
4. We acknowledge that all of the following information has been made available to you for the purposes of performing your procedures:
 - (a) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments of the *[Bank / Company / Branch]**;
 - (b) All relevant instructions, correspondence and minutes or notes of meetings with the Monetary Authority and our solicitors; and
 - (c) Other information which may be relevant to your agreed-upon procedures.

Yours faithfully

[For and on behalf of.....]

Director*/Chief Executive*

* *Delete where not applicable*

APPENDIX 3

Examples of engagement letters

The following example letters highlight only the aspects relating to the scope and responsibilities of auditors for the purpose of reporting under the Banking Ordinance. These examples are for reference only and require the inclusion of other relevant terms of the engagement which will vary according to the requirements and circumstances of individual auditors and their clients. Auditors may consider it appropriate to include a limitation of liability clause in their engagement letter in accordance with their risk management policies.

Example 1 – Engagement letter for reporting under section 63(3) and (3A) for locally incorporated AIs

The Board of Directors
XYZ Bank
[address]

[Date]

Dear Sirs

Engagements to report under section 63(3) and (3A) of the Banking Ordinance

The purpose of this letter is to set out the basis on which we are to act as auditors of XYZ Bank (the “Institution”) under section 63(3) and (3A) of the Banking Ordinance (the “Ordinance”) and the respective areas of responsibility of the directors and of ourselves. The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date].

Set out below are the terms of our engagements and this letter will supersede all agreements, oral and written, in relation hereto, which may exist between the Institution and ourselves and govern the totality of our relationship with you in respect of the work to be done as described therein.

Responsibilities of the directors and auditors

1. Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.
2. Reporting under Section 63(3) of the Ordinance
 - i) It is the directors’ responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.
 - ii) Our duty as auditors is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. We do not assume responsibility towards or accept liability to any other person for the contents of this report.
 - iii) The procedures that we will perform to enable us to form our opinion will be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority and Practice Note 830, “Reports by Auditors Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public

Accountants (“HKICPA”). These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.

- iv) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

3. Reporting under section 63(3A) of the Ordinance

- i) It is the directors’ responsibility to establish and maintain adequate internal control systems to enable:
 - a) the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
 - b) the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
 - c) the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
- ii) Our duty as auditors is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the Monetary Authority, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
- iii) In addition, our duty as auditors is to report whether or not, during the period:
 - a) we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - b) we are aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
- iv) The procedures that we will perform to enable us to form our conclusion will be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority and in accordance with PN 830 issued by the HKICPA.
- v) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

4. The directors are responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 3 above.

5. As part of our normal procedures, we may request you to provide written confirmation of certain representations which we have received from you during the course of the engagements.
6. The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution rests with yourselves, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority.
7. We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services).

[Set out other terms of the engagements as appropriate]

Yours faithfully

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ Bank

**Example 2 – Engagement letter for reporting under section 63(3) and (3A)
for local branch(es) of overseas incorporated AIs**

The Chief Executive
XYZ Bank – Hong Kong Branch
[Branch address]

[Date]

Dear Sirs

Engagements to report under section 63(3) and (3A) of the Banking Ordinance

The purpose of this letter is to set out the basis on which we are to act as auditors of XYZ Bank's Hong Kong Branch (the "Institution") under section 63(3) and (3A) of the Banking Ordinance (the "Ordinance") and the respective areas of responsibility of management and of ourselves. The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date].

Set out below are the terms of our engagements and this letter will supersede all agreements, oral and written, in relation hereto, which may exist between the Institution and ourselves and govern the totality of our relationship with you in respect of the work to be done as described therein.

Responsibilities of management and auditors

1. Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.
2. Reporting under Section 63(3) of the Ordinance
 - i) It is management's responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.
 - ii) Our duty as auditors is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. We do not assume responsibility towards or accept liability to any other person for the contents of this report.
 - iii) The procedures that we will perform to enable us to form our opinion will be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" ("SPM IC-3") issued by the Monetary Authority and Practice Note 830, "Reports by Auditors Under the Banking Ordinance" ("PN 830") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.
 - iv) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

3. Reporting under section 63(3A) of the Ordinance
 - i) It is management's responsibility to establish and maintain adequate internal control systems to enable:
 - a) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
 - b) the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance.
 - ii) Our duty as auditors is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the HKMA, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
 - iii) In addition, our duty as auditors is to report whether or not, during the period, we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.
 - iv) The procedures that we will perform to enable us to form our conclusion will be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority and in accordance with PN 830 issued by the HKICPA.
 - v) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.
4. The Institution's management is responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 3 above.
5. As part of our normal procedures, we may request you to provide written confirmation of certain representations which we have received from you during the course of the engagements.
6. The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution and XYZ Bank rests with yourselves, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority.
7. We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services, or information provided to the head office of XYZ Bank and/or its other branches).

[Set out other terms of the engagements as appropriate]

Yours faithfully

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]

We agree to the terms of this letter.

Chief Executive of XYZ Bank – Hong Kong Branch

**Example 3 – Engagement letter for report of factual findings
in relation to voluntary revocation of authorization**

The Board of Directors
XYZ
[address]

[Date]

Dear Sirs

Engagement to report in relation to the application for voluntary revocation of authorization as a [deposit-taking company/restricted licence bank/bank]* by XYZ

1. The purpose of this letter is to set out the basis on which we are to prepare a report in relation to an application for voluntary revocation of authorization as a [deposit-taking company/restricted licence bank/bank]* by XYZ (the “Institution”). The scope and period to be covered in this engagement are set out in your Letter of Instruction dated [date].
2. Our engagement will be conducted in accordance with Hong Kong Standard on Related Services 4400, “Engagements to Perform Agreed-upon Procedures Regarding Financial Information” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and we will indicate so in our report.
3. We have agreed to perform the following procedures and report to you the factual findings resulting from our work:
 - i) Inspect the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [date].
 - ii) Obtain the Institution’s balance sheet as at [date] prepared by the management of the Institution, and compare it to the books and records.
 - iii) Obtain a summary of contingent liabilities and outstanding commitments as at [date] prepared by the management of the Institution, and compare it to the books and records.
 - iv) With respect to (i) – (iii) above, we will also:
 - a) obtain and review the minutes of the Board of Directors for the period from [date] to [date]; and
 - b) obtain a representation letter from the Board of Directors.
4. The procedures are performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution’s application for voluntary revocation of the authorization as a [deposit-taking company/restricted licence bank/bank]*. Our report is intended for filing with the Monetary Authority. We have no objection that a copy of our report will be given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, our report should not be used for any other purpose.
5. The procedures that we will perform will not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA and, consequently, we will not express any assurance on the Institution’s balance sheet, third party deposit liabilities, contingent liabilities and commitments.

[Set out other terms of the engagement as appropriate]

Yours faithfully

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ

**Delete where not appropriate*

APPENDIX 4

Guidance on ad hoc reports under section 61

The following guidance been prepared to assist auditors in understanding the circumstances in which they would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61 of the Banking Ordinance. Section 61 of the Banking Ordinance does not lay down any rules nor specify the circumstances in which the auditors are to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditors may make matters known to the HKMA without breaching their duty of confidentiality.

All section references in this Appendix are to the Banking Ordinance.

Auditors

1. Section 61 provides that no duty to which an auditor of an AI shall be subject will be contravened “by reason of his communicating in good faith to the Monetary Authority, whether or not in response to a request made by the Monetary Authority, any information or opinion on a matter to which he becomes aware in his capacity as auditor and which is relevant to any function of the Monetary Authority under this Ordinance”. It is this section which makes it clear that auditors are able to communicate with the HKMA by way of a formal report, at a meeting or by any other means on any matters relating to the AI’s affairs arising out of their appointment and which are relevant to any function of the HKMA under the Ordinance. These matters include those which are relevant to the reports made by auditors, to any discussions with the HKMA and to those exceptional circumstances which are referred to in paragraphs 13 and 14 of this Appendix. The HKMA believes that auditors may communicate a matter to the HKMA with the protection of section 61 regardless of the source of that information, provided they become aware of the matter in their capacity as auditors of that client AI.
2. Confidentiality is an implied term of auditors’ contracts with their clients, but in section 61 circumstances it does not prevail since they are entitled to communicate information or opinions relating to the business or affairs of the AI without contravening the duty of confidence owed to the AI. The HKMA recognizes that it would not be appropriate for auditors to report to it, information obtained through their professional relationship with another client which is not the AI.
3. References in the following paragraphs of this guidance to “reporting under section 61” refer to reporting with the protection of section 61.
4. It is important to stress that the HKMA expects that the management of the AI will continue to be its primary source of information and that the normal reporting procedures, including the reports on statutory returns, the prudential meetings and any tripartite meetings will normally provide the HKMA with most of the information it needs to carry out its responsibilities under the Ordinance.
5. Auditors cannot, however, be expected to be aware of all circumstances which, had they known of them, would have led them to exercise their right to report under section 61. That section does not require auditors to change the scope of their audit work, nor the frequency or timing of their audit visits. Auditors do not have an obligation to seek out grounds for making a report under section 61; the section does not place an obligation on auditors to conduct their work in such a way that there is reasonable certainty that they will discover an occurrence of the kind described in paragraph 10 of this Appendix. It is only when auditors become aware in the ordinary course of their audit work of such an occurrence that they would make detailed enquiries with section 61 specifically in mind.
6. The HKMA recognizes that it would not be appropriate for auditors to report to it, information which they have obtained through their professional relationship with another client which is not the AI, even though the information obtained or the matters identified may relate to the AI.
7. Auditors would realize that there are circumstances in which section 61 will not provide protection, for example, where they could be held to have acted maliciously or in bad faith.

The Ordinance does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by the auditors' action in reporting to the HKMA. Auditors would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of their report are such as to secure the protection of section 61 and that it only includes relevant material. However, auditors would recognize that speed of reporting may well be important in order to protect the interests of depositors. There is no protection given by the Ordinance if the auditors fail to report to the HKMA.

The HKMA

8. Information which is confidential and has been obtained by the HKMA under, or for the purposes of, the Ordinance can only be disclosed in given circumstances. However, under section 120(5)(g), the HKMA is not precluded from disclosing information "to an auditor of an authorized institution or former authorized institution or to a former auditor for the purpose of enabling or assisting the Monetary Authority to discharge his functions under this Ordinance". It should be noted that disclosure by the HKMA of confidential information to auditors is to them only; they are not free to pass that information to others, such as their client AI without the HKMA's consent.
9. The HKMA has confirmed that it will take the initiative, usually by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditors:
 - a. when it believes that it is 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
 - b. when the disclosure is for the purpose of enabling or assisting the HKMA to discharge its functions under the Ordinance or will otherwise be in the interests of depositors.

The HKMA will indicate whether management of the AI has been informed of the matter and if so, who has been advised. If the auditors are not informed by the HKMA of any such matter, they are entitled to assume that the HKMA has no such disclosure to make. Accordingly, there is no need for the auditors to request the HKMA to confirm this.

Taking the initiative

10. The HKICPA has developed a criterion for use by auditors in deciding whether to take the initiative in making an ad hoc report in addition to their regular reporting responsibilities. The criterion is that the auditors would take the initiative when they consider it expedient to do so in order to protect the interests of depositors because there has been a material loss or there exists a significant risk of material loss. This criterion can be more fully explained as follows:
 - a. there must be an adverse occurrence, or a change in the auditors' perception of an existing situation, which may include an adverse change in the circumstances of the AI; and
 - b. the position described in a. above has given rise to a material loss or indicates that a reasonable probability exists that a material loss may arise; and
 - c. the position is such that the interests of depositors might be better safeguarded if the HKMA were aware of it.
11. As stated in paragraph 5 of this Appendix, the auditors are not required to seek out grounds for making a report. It is only where they become aware during the ordinary course of their work that the criterion might be satisfied that they would take the matter further.

Reporting via the AI

12. It is important for auditors to act in a manner that will preserve their professional relationship with their client. Normally, therefore, they would ask the AI to draw matters about which they are concerned to the attention of the HKMA. Examples of circumstances encountered in

which the criterion set out in paragraph 10 of this Appendix may be met and the matter reported via the AI are:

- a. when there appears to the auditors to be a material contravention of one or more of the requirements of the Ordinance;
- b. where it has come to the attention of the auditors that there is an extreme situation, such as evidence of imminent financial collapse, where it is obvious that the HKMA must be informed;
- c. where the auditors have evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's net assets;
- d. when the auditors form the opinion that there has been a significant failure of, or that there is a significant weakness in, the accounting and other records or the internal control systems;
- e. when the auditors form the opinion that management has reported financial information to the HKMA which is misleading in a material particular (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).

Reporting direct to the HKMA

13. In exceptional circumstances, where it is in the interests of protecting depositors that the management of the AI should not be informed in advance, the auditors would report direct to the HKMA after first considering the appropriateness of taking independent legal advice. Examples of these circumstances are:
 - a. where there has been an occurrence which causes the auditors no longer to have confidence in the integrity of the directors or senior management, eg. where they believe that a fraud or other misappropriation has been committed by the directors or senior management of the AI, or they have evidence of the intention of directors or senior management to commit such fraud or misappropriation;
 - b. 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, eg. 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 they have evidence of an intention so to act.
14. Additionally, as outlined in paragraph 16.b. of this Appendix, a direct report would be made where the AI will not itself inform the HKMA of a matter, having been advised to do so by the auditors or where it has not done so within the period of time specified, or where there is not adequate evidence that the AI has properly reported the matter in question.

Reporting procedures

15. In forming a view as to whether it is expedient to report a matter to the HKMA, the auditors would follow the procedures in making enquiries and obtaining and assessing relevant evidence which are a normal part of forming a professional judgment in relation to an audit or investigation.
16. Where the auditors become aware of a matter which in their professional judgment they consider ought to be reported to the HKMA, they would consider adopting the following procedures, bearing in mind that speed may be of the essence:
 - a. The auditors would consider the facts and unless inappropriate in the circumstances, discuss the matter with the management of the AI.

- b. In normal circumstances, they would establish whether the matter has already been reported by the AI through the usual channels, and if so, obtain from the AI a copy of the HKMA's written acknowledgement sufficient to establish that the matter has been properly reported.

If the matter has not already been reported by management, the auditors would write to the AI setting out their views and requesting the directors or management to inform the HKMA of the matter, within a specified period of time. They would then obtain from the AI evidence of prompt acknowledgement from the HKMA sufficient to establish that the matter has been properly reported.

In the absence of such evidence, it may be appropriate for the auditors to report the matter direct to the HKMA, and to inform the management of the AI of the contents of their report.

If the directors or management have not informed the HKMA and continue to refuse to inform it within the specified period of time, the auditors would report direct to the HKMA.

- c. If the situation is sensitive, for example in the circumstances outlined in paragraphs 13.a. and b. of this Appendix, it may be inappropriate to discuss the matter with the normal levels of management. The auditors would, therefore, consider reporting to the appropriate senior level within the AI with a view to the HKMA being informed of the situation by a senior representative of the AI. The auditors would then obtain evidence from the AI of prompt acknowledgement by the HKMA sufficient to establish that the matter has been properly reported. In the absence of such evidence, it will then be appropriate for the auditors to report direct to the HKMA.

In exceptional circumstances where the auditors feel that in the interests of speed and/or, because of the nature of the matter, it is not appropriate or practical to inform or discuss the matter with anyone connected with the AI, the auditors would make an appropriate written or other report direct to the HKMA after considering the appropriateness of taking independent legal advice.

17. Auditors would have to satisfy themselves that their decision will stand up to examination at a future date on the basis of the following considerations:
- what they knew at the time;
 - what they should have known in the course of their audit or investigatory work;
 - what they should have concluded; and
 - what they should have done.
18. Speed of reporting will often be important to the protection of the interests of depositors. A report would be made as soon as the auditors reasonably can after forming the view that it is expedient to do so in order to protect the interests of depositors. For auditors this may well mean ensuring that an ad hoc report is made to the HKMA in advance of making their report after considering the appropriateness of taking independent legal advice.
19. Auditors would note that in the situations outlined in paragraphs 13 and 14 of this Appendix, making an ad hoc report alone may not discharge all their responsibilities. An example of this would be auditors considering the implications of the ad hoc report for their opinion on the financial statements.
20. To ensure that the HKMA is informed promptly of matters which meet the criterion, a firm acting as auditors or reporting accountants would ensure:
- a. that all staff responsible for banking and deposit-taking assignments are aware of the provisions of the appropriate legislation and the contents of this guidance, and are able to identify situations in which section 61 might operate; and

- b. that satisfactory procedures exist to ensure that any information, which may be the subject of an ad hoc report, obtained by staff in the course of their work, is passed on to the partner responsible without unnecessary delay.

APPENDIX 5

The Banking Ordinance – Important provisions for auditors

This list is based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

Section

Powers of control over AIs

- 52 The Monetary Authority (MA) has powers to require an AI to take any action the MA deems necessary, to appoint a person to advise on the proper conduct of business, to assume control of the AI, to report matters to the Chief Executive in Council.

Power to examine and investigate AIs

- 55 The MA can examine books and records of an AI and group companies.

Audited financial statements

- 59 An AI and its auditors are required to comply with the Companies Ordinance with respect to the audit of the AI's financial statements; the MA has the power to appoint another auditor.
- 60 Requirement for an AI incorporated in Hong Kong to exhibit its audited financial statements in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch not later than 4 months after the end of the financial year.

Reports on statutory returns used for prudential purposes

- 50(1)(c) The MA can require an auditors' report on returns or information on an overseas branch of an AI incorporated in Hong Kong.
- 63(3) The MA can require an auditors' report on returns or other information submitted to the MA under this section.

Reports on internal control systems

- 59(2) The MA can request ad hoc reports by auditors on certain internal control systems.
- 63(3A) The MA can request recurring annual reports by auditors on certain internal control systems and other matters.

Notification in respect of auditors

- 59A(1) Requirement for an AI incorporated in Hong Kong to notify the MA with respect to proposed or actual changes of auditors.
- 59A(2) Requirement for an auditor of an AI appointed under section 131 of the Companies Ordinance to notify the MA if he resigns, decides not to seek reappointment or decides to qualify the financial statements.
- 63A Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter which, in his opinion, adversely affects the financial position of an AI to a material extent.
- 63B Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter that, in his opinion, is a matter that constitutes on the part of the institution a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities

and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section).

Communication by auditors with the MA

- 61 Ability of auditors to communicate to the MA certain information or opinion notwithstanding duties to clients (whether an AI or a former AI).

Investigations

- 117 Power of the Financial Secretary to appoint competent persons to investigate an AI and a former AI.
- 118 Duty of auditors to provide information etc. to competent persons.

APPENDIX 6

Summary of relevant regulations and requirements issued by the SFC for auditors to fulfil their duties under section 63B

This summary is based on the Securities and Futures Ordinance and its subsidiary legislation which were effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the law for the precise requirements.

Section 157 of the Securities and Futures Ordinance (SFO)

Under section 157(3) of the SFO, “prescribed requirement” means such of the requirements under any of the rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO for the purposes of this definition.

Section 5 of the Securities and Futures (Accounts and Audit) Rules made under section 397(1) of the SFO

The following provisions are prescribed requirements for the purposes of the definition of “prescribed requirement” in section 157(3) of the SFO:

- (a) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
- (b) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
- (c) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules.

The Securities and Futures (Client Money) Rules are rules made under section 149 of the SFO. According to section 63B of the Banking Ordinance, the requirements under section 149 of the SFO or of rules made under that section are excluded.

Securities and Futures (Keeping of Records) Rules

This is a set of subsidiary legislation made under section 151 of the SFO which specifies the records that intermediaries and their associated entities are required to keep, the manner in which they are required to be kept and other matters relating to the keeping of the records.

Relevant sections

- Section 3 General record keeping requirements for intermediaries
- Section 4 Record keeping requirements for associated entities

Securities and Futures (Client Securities) Rules

This is a set of subsidiary legislation made under section 148 of the SFO which prescribes the manner in which intermediaries and their associated entities shall treat and deal with client securities and securities collateral received or held in Hong Kong.

Relevant sections

- Section 4 Requirements in respect of a client’s standing authority
- Section 5 Requirement for deposit or registration of client securities and securities collateral
- Section 10 Limitations on treatment of client securities and securities collateral
- Section 12 Reporting of non-compliance with certain provisions of the Rules

APPENDIX 7 Checklist for auditors

This checklist has been prepared for the guidance of auditors who are required to report on compliance with Parts XII, XV, XVII and XVIII of the Banking Ordinance based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

All section references in this Appendix are to the Banking Ordinance.

Answer the following questions for the period to be covered by the report only:

**Section
Ref.**

Part XII Disclosure of Information

1. Returns and information required by the HKMA

- | | |
|-----------|---|
| a. | Returns and information |
| 63(1) | Did the AI submit the required monthly and quarterly returns and such other information to the HKMA within the required 14 days or such period as the HKMA may require? |
| b. | Matters which adversely affect the financial position of the AI to a material extent |
| 63A | Are you aware of any matter that may adversely affect the financial position of the AI to a material extent? If so, a report in writing on the nature of the matter and the reason supporting this opinion are required to be submitted to the HKMA. |
| c. | Failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance |
| 63B | Are you aware of any matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section)? If so, a report in writing on the matter is required to be submitted to the HKMA as soon as reasonably practicable. |
| d. | Shareholding |
| 64(1)&(2) | Has the AI informed the HKMA of the name, address, nature of business and other information required about companies: |
| i. | in which the AI beneficially holds 20% or more of the share capital; |
| ii. | where any director or manager of that company is also a director, chief executive or manager of the AI; |
| iii. | where the name of that company has common features with the name of the AI; |
| iv. | which, by whatever means, acts in concert with the AI to promote the AI's business; or |
| v. | the controller of which is also the controller of the AI. |

- e. Changes to constitution
- 65 Are there changes to the constitution of the AI of which the HKMA has not yet been notified within the required 30 days?
- f. Cessation of business
- 66 Has the AI ceased to carry on banking/deposit-taking business and if so, has it notified the HKMA in writing?
- g. Inability to meet obligations
- 67(1) Is the AI likely to become unable to meet its obligations or is it about to suspend payment? If so, has it notified the HKMA?
- 2. Maintenance of adequate provision for depreciation and diminution in value of assets**
- 63(3A) Has the AI at all times during the period under examination had in place systems of control which are adequate to enable it to maintain adequate provision:
- a. for depreciation;
 - b. against the diminution, if any, in the value of its assets, including provision for bad and doubtful debts;
 - c. for liabilities which will or may fall to be discharged by it; and
 - d. for losses which will or may occur?

Part XV Limitation on Loans by and Interests of AIs

- 3. Advance against security of own shares**
- 80 Has the AI complied with the requirement not to grant any advances, loans or credit facilities (including letters of credit) or give any financial guarantee or incur any other liability:
- a. against the security of its own shares; and
 - b. against the security of the shares of
 - 80(2) i. any holding company of the AI;
 - ii. any subsidiary of the AI; or
 - iii. any other subsidiary of any holding company of the AI,
 except with the approval in writing of the HKMA?
- 4. Limitation on advances**
- 81(1) a. Has the AI instituted an adequate and effective management control to ensure that its financial exposure to:
- i. any one person;
 - ii. any two or more companies which have the same holding company;

- iii. any two or more companies which have the same controller;
- iv. any holding company and one or more of its subsidiaries;
- v. any one person and one or more companies of which that person is a controller,

does not exceed 25% of its capital base?

Notes:

- 81(2) [1] *Financial exposure for this purpose means the aggregate of:*
- [a] *all advances, loans and credit facilities (including letters of credit) by the AI;*
 - [b] *the value of the AI's holdings of shares and debentures and other debt securities issued by that company, person or combination thereof;*
 - [c] *financial exposures (declared in a notice to be financial exposure) of the AI to that company, person or combination thereof; and*
 - [d] *the principal amount, multiplied by a factor specified by the HKMA and published in the gazette - for items referred to in Table B of the Third Schedule to the Ordinance.*
- 81(6) [2] *Financial exposure does not include:*
- *exposure to other AIs;*
 - *exposure to an overseas incorporated bank which is not an AI where it is, in the opinion of the HKMA, adequately supervised by the relevant banking supervisory authority;*
 - *exposure to the extent to which it is secured by a cash deposit, a guarantee, an undertaking which is similar to a guarantee, or securities issued, or guaranteed, by the central government or the central bank of any Tier 1 country within the meaning of the Third Schedule to the Banking Ordinance and such collateral or guarantee is accepted by the HKMA. The general criteria that the HKMA will apply in assessing whether such collateral or guarantee is acceptable are set out in the HKMA's Supervisory Policy Manual CR-L-2 "Exemption of Financial Exposures: §81(6)(b)(i)";*
 - *exposure to the extent to which it is covered by a letter of comfort accepted by the HKMA. See CR-L-3 "Letters of Comfort: §81(6)(b)(ii)" for the criteria that the HKMA will apply in assessing whether such letters of comfort are acceptable;*
 - *exposure acquired by the purchase of bills of exchange or documents of title to goods where the holder of such bills or documents is entitled to payment outside Hong Kong for goods exported from Hong Kong;*
 - *advances, loans and credit facilities made against the bills or documents mentioned above;*
 - *exposure to the Hong Kong Special Administrative Region Government or any other government acceptable to the HKMA;*
 - *share capital or debt securities held as collateral for facilities granted or acquired by the AI during debt recovery. In the latter case, the AI is, however, required to dispose of such collateral at the earliest possible opportunity, and in any case within 18 months after the acquisition or within such further period as may be approved by the HKMA;*
 - *an indemnity issued by the AI to a person to protect that person from any damages which may be incurred as a result of the person registering a transfer of shares (e.g. lost share certificates), provided that certain specified conditions are met;*

- exposure acquired under an underwriting or sub-underwriting contract. If the exposure is an on balance sheet item, the exemption will only last for a period not exceeding seven working days or such further period as may be approved by the HKMA (see the HKMA's Supervisory Policy Manual CR-L-4 "Underwriting of Securities: §§81 and 87" for the HKMA's policy on extending the exemption period for the underwriting or sub-underwriting of securities);
- exposure to a multilateral development bank as defined in the Third Schedule to the Banking Ordinance;
- exposure to the Housing Authority arising from guarantees given to AIs under the Home Ownership or Private Sector Participation Scheme;
- exposure to The Hong Kong Mortgage Corporation Limited (HKMC) arising from its obligations under the Mortgage Insurance Programme;
- exposure to the extent that it has been written off or specifically provided for in the books of the AI; and
- exposure to the HKMC or any company that issues mortgage-backed securities in connection with the HKMC's Guaranteed Mortgage-Backed Pass-Through Securitisation Programme, if the exposure to the HKMC or the company arises from the obligations placed upon it for the purposes of the Programme.

b. Are you aware of any financial exposure of the AI during the period under review which was in contravention of this limitation?

81(6) c. In respect of transactions covered by a "letter of comfort", is the aggregate amount of the financial exposure within the limitation imposed by:

- the HKMA; or
- the terms of the letter of comfort?

Notes:

[1] This section does not apply to AIs incorporated outside Hong Kong.

79A [2] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

5. Compliance with guidelines on business practices

82(1) Has the AI complied with the requirement not to engage in those business practices specified in the guidelines, if any, published by the HKMA, after consultation with the Financial Secretary by notice in the Gazette?

Notes:

[1] The HKMA has the discretion to prohibit those business practices, which it considers will or may cause the soundness of the financial position of AIs to be dependent upon the soundness of the financial position of a single party.

82(2) [2] Such guidelines may apply to all AIs or to a class of AIs as specified in the notice.

[3] Such guidelines may specify what constitutes a single party and, without prejudice to the generality of that power, any class or description of persons or business may constitute such a single party.

6. Limitation on advances to directors etc.

83 a. Has the AI instituted an adequate and effective management control to ensure that it does not grant, or permit to be outstanding, any unsecured* advances, loans, credit facilities, financial guarantees or incur any other unsecured* liability to:

- 79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.
- 83(4) i. any director of the AI;
 ii. any relative of such director;
 iii. any employees responsible, either individually or as a member of a committee, for approving loan applications;
 iv. any relative of any such employee;
 v. any controller of the AI;
 vi. any relative of an individual who is a controller of the AI;
 vii. any firm, partnership or non-listed company in which the AI or any of its controllers or its directors (or relative of its controllers or directors) is interested as director, partner, manager or agent; and
 viii. any individual, firm, partnership or non-listed company of which any of the AI’s controllers or directors (or relative of its controllers or directors) is a guarantor,
- 83(1) to an aggregate amount in excess of
 aa. 10% of the capital base of the AI; or
- 83(2) bb. 5% of the capital base of the AI in respect of one or more persons included in i. to vi. above; or
 cc. \$1,000,000 in respect of any one person included in i. to vi. above.
- b. Are you aware of any loans or advances etc. granted or outstanding during the period under examination which were in contravention of any of these limitations?

Notes:

- 83(5) [1] *The above shall apply to a facility granted jointly with another party as they apply to a facility granted severally.*
- 83(1) [2] *The above section does not apply to AIs incorporated outside Hong Kong.*
- 79A [3] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

7. Limitation on advances to employees

- 85 Has the AI complied with the requirement not to grant, or permit to be outstanding, unsecured* advances, loans, credit facilities to, and not to give unsecured* financial guarantees or incur any other unsecured* liability in respect of, any one of its employees to an aggregate in excess of one year’s salary for any such employee?
- 79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA, be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.

8. Moneys placed with foreign banks

86 Is there any notice from the HKMA prohibiting the AI from granting any advances, loans, deposits or credit facilities to or directing the AI to demand repayment from any foreign banks?

Note:

86(4) *“Foreign bank” means:*

[1] *any bank incorporated outside Hong Kong which is not licensed under the Banking Ordinance;*

[2] *any undertaking of an AI which is situated outside Hong Kong.*

9. Limitation on shareholding

87(1) Has the AI complied with the requirement not to acquire or hold any share capital of another company or companies of an aggregate value which exceeds 25% of the capital base of the AI except that:

- a. such share capital is held as security for facilities granted by the AI; or
- b. such share capital is acquired in the course of satisfaction of debts due to the AI. In any event, such acquisitions must be disposed of within 18 months unless the HKMA has agreed to an extension of time.

87(2) c. by virtue of specified underwriting contracts; or

- d. in respect of shareholdings, approved in writing by the HKMA, in another AI or in a company carrying out nominee, executor or trustee functions or other functions related to banking/deposit-taking business or other financial services;
- e. in respect of any holding, approved by the HKMA, of share capital which is deducted in determining the capital base of the AI?

87A Has the AI complied with the requirement not to acquire all or part of the share capital of a company to a value of 5% or more of the capital base of the AI at the time of the acquisition except with the approval of the HKMA?

Notes:

87(1) [1] *This section does not apply to AIs incorporated outside Hong Kong.*

79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

10. Limitation on holding of interest in land

88(1) Has the AI complied with the requirement not to purchase or hold any interest in land situated in or outside Hong Kong of an aggregate value which exceeds 25% of its capital bases excluding:

- 88(2)/(3) a. land necessary for occupation for its business purposes or for staff housing; and
- 88(5) b. the value of land mortgaged to the AI by way of security for debts due to the AI, or the value of any interest acquired pursuant to entry into possession of land so mortgaged, provided that such mortgaged land must be disposed of within 18 months unless the HKMA has agreed to an extension?

Notes:

- 88(1) [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

11. Limitation on aggregate holdings

- 90(1) Has the AI complied with the requirement not to permit its aggregate holdings of:
- a. amounts outstanding of all facilities granted to specified bodies (as defined in section 83(3)&(4));
 - b. shareholdings in other companies (as defined in section 87); and
 - c. interests in land (as defined in section 88(1)&(2)),
- to exceed 80% of the capital base of the AI?

Notes:

- [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

Part XVII Capital Adequacy Ratio

12. Capital adequacy ratio

- 98(1) Has the AI maintained at all times during the period under review a capital adequacy ratio of more than the percentage stipulated by the HKMA as calculated in accordance with the provisions of the Third Schedule?
- 101(1)

Notes:

- 100(1)&(2) [1] *If the AI contravenes section 98(1) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.*
- 3rd Sch. [2] *The capital adequacy ratio shall be calculated as the ratio, expressed as a percentage, of its capital base to its risk weighted exposure as specified in the Third Schedule.*
- 98(2) [3] *If the AI has a subsidiary, the HKMA may, by notice in writing, require the capital adequacy ratio to be calculated on a consolidated basis, or both consolidated and unconsolidated basis. The notice may specify those subsidiaries to be included.*
- 98(2A)
- 98(3) [4] *The minimum percentage requirement may be varied by the Financial Secretary by notice in the Gazette.*
- 101(1) [5] *The percentage requirement of 8% may also be increased by the HKMA to not more than 12% for a particular bank, or 16% for a particular restricted licensed bank or deposit-taking company.*
- 98(1) [6] *The requirement does not apply to AIs incorporated outside Hong Kong.*

Part XVIII Liquidity Ratio and Matters Affecting Liquidity Ratio

13. Liquidity ratio

102(1) Has the AI maintained in the period under review a liquidity ratio of not less than 25% as calculated in accordance with the provisions of the Fourth Schedule and Part XVIII?

Notes:

4th Sch. [1] *The liquidity ratio shall be calculated as the ratio, expressed as a percentage, between its liquefiable assets and its qualifying liabilities, as specified in the Fourth Schedule to the Ordinance.*

102(3) [2] *Assets and liabilities of branches outside Hong Kong shall not be taken into account in the computation of the liquidity ratio.*

102(4) [3] *The minimum percentage limit may be varied by the Financial Secretary by notice in the Gazette.*

105(1) [4] *The percentage limit for a particular AI may also be varied by the HKMA.*

14. Charges over assets

106(1) Has the AI complied with the requirement that the sum total of all amounts secured by way of charge over its assets (excluding contra items) is less than 5% of the sum total of the value of those assets unless the HKMA has approved a higher amount?

Notes:

[1] *This section does not apply to AIs incorporated outside Hong Kong.*

106(2) [2] *The MA may, by notice in the Gazette, specify a charge, or a class of charges, to which the above section shall not apply.*

15. Civil proceedings

106(3) Has the AI any civil proceedings instituted against it which materially affect, or could materially affect, the financial position of the AI and which have not been notified to the HKMA?

Note:

This section does not apply to AIs incorporated outside Hong Kong.