

PN 830 (Revised)  
Issued December 2014; revised April 2016,  
revised December 2018

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Effective for reporting periods ending  
on or after 1 January 2019

*Practice Note 830 (Revised)*

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# **Reports by the Auditor under the Banking Ordinance**



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

**PRACTICE NOTE 830 (REVISED)**

**REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE**

(Issued December 2014; revised April 2016, revised December 2018  
*Effective for reporting periods ending on or after 1 January 2019*)

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<p>Practice Note (PN) 830 (Revised), <i>Reports by the Auditor under the Banking Ordinance</i> should be read in the context of the "Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements" which sets out the application and authority of PNs.</p>
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**PRACTICE NOTE  
830 (REVISED)  
REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE**

*The purpose of Practice Notes issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) is to assist the auditor in applying Hong Kong Engagement Standards of general application to particular circumstances and industries.*

*Practice Notes are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in Hong Kong Engagement Standards. This Practice Note provides guidance to assist the auditor to fulfill the objectives of the engagement. The auditor should be prepared to explain departures when called upon to do so.*

**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 the auditor of authorized institutions ("AIs") in reporting under the Ordinance.
3. This PN provides guidance to members on the reporting responsibilities of the auditor 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 the auditor, 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 the auditor 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 auditor's 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 audit of the financial statements of an AI and does not apply to other reports provided by the auditor, such as those provided under the Companies Ordinance on financial statements. Guidance on auditor's report on financial statements is set out in HKSA 700, "Forming an Opinion and Reporting on Financial Statements" and Practice Note 600.1 (Revised) "Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)".
6. In addition to the reporting responsibilities under the Ordinance, the auditor is 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. The auditor may also be required by the Deposit Protection Board to report on the Return of Relevant Deposits for the purpose of the Deposit Protection Board. This PN does not provide guidance with respect to these responsibilities.
7. This PN also contains in Appendix 5 a guide to the relevant provisions for the auditor in the Ordinance which were effective as at 31 July 2018. 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 auditor's reports under the Ordinance.
10. The PN has been prepared in consultation with the HKMA.

## PART II – AUDITOR'S REPORTING RESPONSIBILITIES UNDER THE ORDINANCE

### Introduction

11. The auditor is 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 the auditor as a person 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 auditor") 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 the auditor under the Ordinance (except reporting under section 59(2)) is normally carried out by an AI's statutory auditor although the HKMA has the right to commission reports from another audit firm where:
- a. such an arrangement can better utilize the knowledge and expertise of different auditor which may be beneficial to the AI; or
  - b. the HKMA has reason to believe that the statutory auditor would not be capable of producing an adequate report, after taking into account:
    - the reputation of the statutory auditor;
    - the quality of reports previously submitted to the HKMA by the statutory auditor;
    - the expertise, knowledge and resources of the statutory auditor; and
    - any potential conflict of interest on the part of the statutory auditor.

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

12. The auditor has 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 67 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 68 to 104 below).
  - b. Other reports
    - Ad hoc reporting on internal controls, specific transactions or any other matters (section 59(2)) (see paragraphs 105 to 127 below);
    - Notification of audit qualifications or adverse statements in audit reports on AI's financial statements (section 59A(2)(c)) (see paragraphs 128 to 130 below);
    - Reporting of significant adverse matters and non-compliances (sections 63A and 63B) (see paragraphs 131 to 139 below);
    - Notification of resignation of the auditor (section 59A(2)) (see paragraph 140 below);

Apart from the specific provisions in the Ordinance set out above, the HKMA may also reasonably require the AI to appoint an auditor to examine and report upon specific subject matters or transactions undertaken by the AI as it deems fit for the exercise of its supervisory functions under the Ordinance. The auditor may want to consider the

guidance set out in this PN in discharging its reporting responsibilities under these circumstances as appropriate.

- c. Under section 50(1)(c), locally incorporated AIs which maintain an overseas branch may need to appoint an auditor, 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. The auditor is also normally requested to furnish a report on voluntary revocation of an AI's authorization to the HKMA in respect of the balance sheet<sup>1</sup>, third party deposit liabilities, contingent liabilities and outstanding commitments (see paragraphs 141 to 146 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"<sup>2</sup>, 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. The auditor would have regard to the requirements set out in Supervisory Policy Manual IC-3 in fulfilling the reporting responsibilities under the Ordinance.

## General guidance

### Types of engagements under the Ordinance

15. The auditor's reporting responsibilities under the Ordinance can generally be categorized as either reasonable assurance engagements, limited assurance engagements, or agreed-upon procedures engagements. The auditor may also provide other forms of reporting on specific subject matter (e.g. review and comment report for an investigation of particular subject matter under section 59(2) of the Ordinance) at the request of the HKMA. The form of such reporting will be determined on a case-by-case basis after taking into account the scope of work required and level of assurance expected by the HKMA.
16. As defined in Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, a reasonable assurance engagement is an assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.
17. As defined in HKSAE 3000 (Revised), a limited assurance engagement is an assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated.
18. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed, and to report on factual findings. As the auditor simply provides a

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<sup>1</sup> Different term like statement of financial position may be used in the auditor's report as long as it is consistent with the title of the corresponding statement.

<sup>2</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

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 auditor and draw their own conclusions from the auditor's work.

### Overview of the reporting process

19. The following are action steps that the auditor would consider in order to discharge the 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 specific banking returns or systems of control to be reported on and the period to be covered;
- Issue a letter of engagement;
- If applicable, obtain the relevant banking returns to be reported on from the AI. In the anticipation of the update of the HKMA's Supervisory Policy Manual IC-3<sup>3</sup>, the HKMA has indicated that the returns to be reported on by the auditor would be the latest returns submitted to the HKMA before the commencement of auditor's work (the "Relevant Returns"), unless the HKMA specifies otherwise;
- Where a relevant return has been revised from the originally submitted return, obtain a reconciliation of adjustments between originally submitted return and the Relevant Return from management. Such a reconciliation should contain information as set out in Part A of Appendix 9 of this PN;
- 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 should be present), where appropriate, to obtain the background information, including the reasons why the HKMA is requesting the report and the expectations of the HKMA with respect to the engagement. Depending on individual circumstances, the auditor would usually seek to discuss and agree the scope, nature and extent of work with the HKMA and AI through such a meeting;
- Where necessary, hold additional scoping meeting(s) or discussions 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;

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<sup>3</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.



- 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 auditor (if necessary). Ensure that any significant changes in scope are properly described in the report to be issued.

*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 auditor's 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, the auditor would recognize that throughout the process, there are two parties interested in the report - the AI which engages the auditor; and the HKMA, which has required the AI to commission the report. The auditor would manage the expectations of both parties to reduce the risk of misunderstanding.
22. The auditor 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 usually there will be value in holding discussions involving the auditor concerning the proposed assignment in a tripartite meeting (between the AI, the HKMA and the auditor) or, in less usual circumstances, a bilateral meeting (between the HKMA and the auditor only) but is not bound to do so. This

discussion can usually 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, the auditor would consider the professional skills required to undertake the engagement.
25. In particular, the auditor 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 auditor's report would be presented. In addition, the auditor is 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. The auditor would need to consider whether previous or existing professional relationships could present a conflict of interest in accepting the engagement. If the auditor becomes aware of relationships with the AI which could be construed as a conflict of interest, the auditor would advise the AI and the HKMA of this issue and all parties have to be satisfied that the auditor is 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 auditor and the need for a fresh perspective on matters to be examined when deciding whether to nominate or approve the appointment of the statutory auditor or another audit firm.
28. The auditor 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. The auditor would follow the guidance set out in HKSA 210, "Agreeing the Terms of Audit Engagements" and agree the terms of the engagement in relation to the auditor's 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, the auditor 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. The auditor would include specific findings such as exceptions, deficiencies, 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. The auditor 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, the auditor 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. The auditor 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 the auditor 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, the auditor would normally report all relevant matters other than those considered to be immaterial. This PN provides further guidance for the auditor on materiality for the purpose of the reporting responsibilities under the Ordinance (see paragraphs 60 to 61, 95 to 99 and 120 to 121 below for different engagements).
33. Unless otherwise agreed with the HKMA, where an auditor's engagement for the purpose of reporting under the Ordinance includes the examination of controls over a specified period or transactions during that period, the auditor would include all material findings identified even if the findings identified were corrected during or after the period examined.
34. The auditor would seek management's confirmation of the factual accuracy of information or statements contained in the auditor's 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. For certain types of engagements under the Ordinance (e.g., section 63(3A) reports and section 59(2) reports), the HKMA expects management of the AI to have the opportunity to provide written comments on exceptions contained in the auditor's report prior to its submission to the HKMA. Management may wish to provide the auditor with written comments for incorporation into the auditor's 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 the auditor includes 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 the auditor takes no responsibility for them and that they are not covered by the auditor's 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 auditor's 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 auditor's 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 the auditor issues a report without incorporating management's comments, the auditor would obtain a copy of any comments that management submits directly to the HKMA.

### **Auditor's report 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 auditor, as to whether or not, in the opinion of the auditor, 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 the auditor's report on banking returns is provided in the HKMA's Supervisory Policy Manual IC-3<sup>4</sup>.

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<sup>4</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

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 an auditor 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 the banking returns. Such information also falls within the scope of information to be reported upon by the auditor 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 the auditor performs for the purpose of reporting under section 63(3) is a reasonable assurance engagement. The responsibility for correct compilation of returns or other information submitted to the HKMA rests with the management of the AI and the auditor's responsibility is to report on whether specified AI's returns or other information submitted to the HKMA are correctly compiled, in all material respects, from the books and records of the AI based on procedures the auditor performed. Reference should be made to Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised) 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 the auditor. It should also be noted that for certain returns, the auditor would normally report only on specified parts of the return. For a locally incorporated AI, the auditor would normally be required to report on all or some of the following returns:
  - Return of Capital Adequacy Ratio (All parts);
  - Return of Large Exposures (Parts I, II and III, columns 1 – 5);
  - Return of Liquidity Position (Part 1 (section (I)) and Part 2 if the AI is a "category 1 institution"; or Part 1 (section (II)) and Part 3 if the AI is a "category 2 institution" – see Appendix 11 paragraph (c));
  - Quarterly Analysis of Loans and Advances;
  - Return of Mainland Activities; and
  - Certificate of compliance with the Ordinance (Parts I – IV).

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, the auditor would normally be required to report on all or some of the following returns:

- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part 1 (section (I)) and Part 2 if the AI is a "category 1 institution"; or Part 1 (section (II)) and Part 3 if the AI is a "category 2 institution" – see Appendix 11 paragraph (c));
- Quarterly Analysis of Loans and Advances;
- Return of Mainland Activities; and
- Certificate of compliance with the Ordinance.

The HKMA can also require the auditor to report on any other returns, or other information submitted to it under section 63(1) and (2) (and section 50(1)(a) and (b)) as the HKMA considers necessary for a particular AI.

44. The returns to be reported on are normally the most comprehensive in the series. That is, where an AI completes a consolidated return<sup>5</sup>, 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 anticipation of the update of the HKMA's Supervisory Policy Manual IC-3<sup>6</sup>, the HKMA has indicated that the Relevant Returns to be reported on by the auditor would be the latest returns submitted to the HKMA before the commencement of auditor's work, unless the HKMA specifies otherwise. Auditors should specify in their reports the submission dates of the returns that have been reviewed by them.

#### **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 auditor would normally review copies of the following documents when planning the work:
- a. in respect of locally incorporated AIs, if it is not the statutory auditor, the latest audited financial statements of the AI together with a copy of the latest management letter issued by the statutory auditor where relevant. The auditor would also seek the AI's permission to discuss any matters relevant to the examination with the statutory auditor;
  - b. for AIs being branches of overseas incorporated banks, the reporting package or accounts prepared (audited or unaudited) by the AIs for submission to their parent banks for group consolidated financial reporting purpose;
  - c. all correspondence and all minutes or notes of meetings that the AI has held with the HKMA which are relevant to the auditor's examination of the internal control systems in relation to the Relevant Returns;
  - d. all internal audit reports for matters that may have implications on section 63(3) reporting;
  - e. all board and management committee minutes;
  - f. the Relevant Returns submitted to the HKMA, together with any amendments submitted thereafter.

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<sup>5</sup> For liquidity supervision and reporting purposes, an AI's consolidated position may include "specified associated entities" as defined in rule 2(1) of the Banking (Liquidity) Rules.

<sup>6</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

**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 the auditor to state whether, in the auditor's opinion, the returns have been correctly compiled, in all material respects, from the books and records of the AI. Accordingly, the work the auditor is 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. The auditor would consider books and records to include the accounting records, i.e. general ledger (including sub ledgers) and non-accounting records such as 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. For the purpose of reporting under section 63(3), the auditor would primarily focus on the "downstream" process of extracting data from books and records for the purpose of compiling the banking returns rather than the "upstream" processes that operate to bring data originating from transactions and source documents into systems that produce the books and records. Therefore, the books and records will normally be the transactional level records maintained in the AI's relevant established systems ("downstream" records) and normally do not include the primary source supporting documents ("upstream" records) to these transactional level records.
52. There is no requirement for the auditor 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 the 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 books and records. For accounting records, the books and records would normally be the general ledger or sub ledgers whilst for non-accounting records, these would normally be reports generated from established systems that produce or maintain the relevant transaction records; and, where applicable, the auditor should reconcile the amounts contained in the working papers to the general ledger or sub ledgers and/or test-check the information contained in the working papers to reports generated from or database of the established systems. Nevertheless, depending on the risks assessed and circumstances encountered by the auditor during the course of his work (e.g., when the AI has applied or embedded certain interpretations or classification criteria in the completion instructions of the Relevant Returns as part of the "upstream" processes to produce the books and records), additional testing procedures over the books and records should be considered and adopted by the auditor as appropriate.
53. Any material adjustments made to the books and records in the course of compiling the returns should be considered as part of assessing whether the return has been correctly compiled. The auditor 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.
54. As the auditor's work normally involves testing items on a sample basis, the auditor would consider the adequacy of the compilation process adopted in the preparation of the Relevant Returns as part of the determination of the sample sizes. For example, the auditor would consider whether the definitions and interpretations used in compiling the information are appropriate, whether the controls are adequate to prevent and detect errors in the

compilation of the banking returns, and whether known issues are taken into account in the compilation process. The auditor would refer to HKSA 530, "Audit Sampling" for further guidance in this regard.

55. 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. Such interpretation is important as definitions and requirements set out in the Ordinance and the HKMA's completion instructions may be worded in a general fashion and management would need to determine how such definitions or requirements should be applied to specific businesses or processes of an AI. Where issues relating to interpretation of the requirements or definition arise, the auditor would consider the following procedures in order to determine whether appropriate interpretation has been adopted:
- Review the documentation maintained by the AI, including any consultation sought with the HKMA, to 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;
  - Determine the need to include an appropriate description of the interpretation adopted to form the basis of the opinion within the auditor's report if in the auditor's judgement, such interpretation is of such importance that it is fundamental to the users' understanding of the information presented in the Relevant Returns. Typically, this can be achieved through including an Emphasis of Matter paragraph in the auditor's report which provides a clear description of the specific interpretation adopted by the AI. The auditor would refer to HKSAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* for further guidance in this regard.

#### *Testing procedures*

56. The specific procedures to be performed by the auditor in examining the returns for the purpose of reporting under section 63(3) may vary according to the nature, complexity and basis of compilation adopted by the AI for each of the individual returns. Guidance on specific procedures for returns that are more frequently required by the HKMA to be reported on under section 63(3) are set out in Appendix 11 of this PN for reference.
57. The general procedures which the auditor would carry out in respect of the work on the examination of returns for the purpose of reporting under section 63(3) include:
- Obtain an understanding of the purpose and the completion instructions for the Relevant Returns. The purposes of specific returns are taken into consideration in assessing the materiality of any exception identified;
  - 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;
  - Understand management's process of compiling the Relevant Returns including any controls that operate to ensure complete and accurate compilation;

- Check that the compilation of amounts in the returns is in accordance with the relevant completion instructions and definitions;
- 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 whether only amounts which meet the relevant criteria are included in specific line items;
- Reconcile totals to the books and records where appropriate.

### **Representations by management**

58. The auditor would follow the guidance in HKSA 580, "Written Representations" 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 and non-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 the returns provided to the auditor for the purpose of this engagement are the Relevant Returns submitted to the HKMA;
  - c. 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;
  - d. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondences with the HKMA, etc.) for the purpose of the auditor's examination of the returns, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
  - e. stating whether there have been any communications between regulatory authorities and the AI concerning non-compliances with laws and regulations 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;
  - f. the returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the HKMA;
  - g. management acknowledges their responsibility for the preparation of the reconciliation summarizing adjustments made between the original and the Relevant Return (if any);
  - h. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVIIA (for locally incorporated AIs only) or XVII B of the Ordinance during the relevant period;
  - i. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report; and



- j. Management has communicated to the auditor all deficiencies in internal control of which they are aware of that could have a material effect on the information presented in the returns.
59. An example management representation letter is set out in Appendix 2 to this PN – Example 1.

**Materiality**

60. The HKMA requires errors to be reported where such errors make a material difference to a Relevant Return or are indicative of significant weaknesses in the compilation process. What constitutes material will need to be judged by the auditor on a case-by-case basis but the focus is on the impact on the Relevant Return subject to examination and/or other Relevant Returns that are within the scope of section 63(3) reporting rather than on minor reporting errors.
61. As the specific purpose of each banking return is different, consideration of materiality may need to be varied accordingly and requires an understanding of the purpose of the return and how the information that is reported in the return affect that purpose. A two-tier approach could be considered in which the auditor would assess whether an error is material not only by a general quantitative reference (for example, a difference of 5% or more in a particular line item) but also with reference to relevant benchmarks applicable based on the purpose of the specific return. For example, even where the absolute amount of an error identified in the Return of Capital Adequacy Ratio is not material quantitatively (i.e. does not result in a difference of 5% or more in a particular line item), if it leads to a breach of regulatory Capital Adequacy Ratio limit, such an error will be considered as material. A similar approach can also be considered for other returns such as the Return of Liquidity Position. Notwithstanding the above, the auditor should apply professional judgement in determining the appropriate materiality benchmarks for individual returns. Further guidance on the two-tier materiality approach and suggested materiality benchmarks for the more common returns are included in Appendix 10 of this PN for reference. In addition, the auditor should consider whether the errors identified are individually material or material in aggregate and the qualitative aspects of the errors. Material errors, regardless of their causal factors, should be reported to the HKMA. In this connection, the auditor should gather sufficient evidence to form such judgement. It is expected that the auditor should exercise professional judgement after due consideration of an AI's size, risk profile, business activities and strategy in determining whether any identified error would be of major concern to the HKMA and hence warrant reporting under section 63(3) of the Ordinance.

**Reporting**

62. A material error would be reported together with an appropriate description of the error as well as the impact on the Relevant Return. Adjustments made as part of finalizing the financial statements or accounting books closing should normally be reflected in the books and records from which the banking returns are compiled. Nevertheless, in certain circumstances and depending on the timing of an AI's financial statements finalization and accounting books closing process, such adjustments may not have been made in the originally submitted returns but are reflected in a revised return which is the Relevant Return. Such adjustments would not be regarded as errors for section 63(3) reporting purposes. However, due care should be exercised by the auditor to evaluate and conclude whether an adjustment made by the AI is exclusively due to timing of AIs' financial statements finalization and accounting books closing process or in fact due to error which should otherwise be captured for section 63(3) reporting purposes.
63. Where errors are identified and there is evidence to suggest that weaknesses in internal controls exist, the auditor would also consider including in the report under section 63(3A) the observations and recommendations on the relevant internal controls for the HKMA and the AI to gain a fuller understanding of the implications of the auditor's findings (see paragraphs 100 to 104 below).

64. An identical copy of the Relevant Returns on which the auditor's report is based would accompany the auditor's report. A summary of the material errors identified by the auditor is recommended to be reported in the format suggested in Part B of Appendix 9 of this PN and set out either within the body of the auditor's report or in an appendix, reference to which is made in the auditor's report.
65. In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised). Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).
66. The auditor should carry out a reasonable assurance engagement in accordance with HKSAE 3000 (Revised) and with reference to this PN. The auditor's 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. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 (Revised) and with reference to PN 830 (Revised). The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor 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 auditor's report together with any comments thereon. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.
67. Examples of auditor's reports under section 63(3) are set out in Appendix 1 to this PN – Examples 1 and 2. An example of a modified auditor's report is set out in Appendix 8 to this PN – Example 1.

### **Auditor's report under section 63(3A)**

#### **General**

68. 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.
69. 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 auditor.
70. The HKMA has interpreted the requirements of the Ordinance in various modules of its Supervisory Policy Manual. The auditor 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.
71. The HKMA will require AIs to appoint the auditor 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 auditor's 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 the opinion, the auditor would have regard, inter alia, to the nature and scale of the business of the AI. The auditor 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).
72. 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 auditor is unlikely to be able to rely solely on the work carried out for the purpose of auditing the financial statements

and therefore the auditor would adopt additional procedures for the purpose of reporting under section 63(3A).

73. 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 auditor.

### Scope

74. The work that the auditor performs 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 auditor's responsibility in providing reasonable assurance is to report on whether certain internal controls were in place during the relevant period. Having performed the work, the auditor is then required to report under section 63(3A)(b) on whether the auditor is 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 aspect of the engagement is providing limited assurance and is based not only on the work performed under section 63(3A)(a) but also any other relevant information which comes to the attention of the auditor in the normal course of the audit work or in the examination of returns under section 63(3). The auditor will not, however, be expected to change the scope of the audit work nor the frequency or timing of the audit visits. Reference should be made to HKSAE 3000 (Revised) for details on the standards and guidance in this regard.
75. The HKMA is empowered under section 63(3A)(a) to require an AI to submit a report by the auditor 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, XVIA (for locally incorporated AIs only) and XVIB 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.
76. Having completed the work on the specified internal controls, the auditor 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, XVIA (for locally incorporated AIs only) and XVIB 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.
77. 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

78. 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 records of the AI.

Examples of procedures that the auditor may have regard to in assessing adequacy of controls are set out in the HKMA's Supervisory Policy Manual IC-3<sup>7</sup>, Annexes A to C.

79. The auditor 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). Nevertheless, auditors should be aware of the differences in scope and focus of these examinations in their deliberation.

#### **Controls over compilation of returns and information from books and records**

80. The auditor's 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 controls over the return compilation process of an AI.
81. 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 auditor is 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 HKMA expects that statistics and information would be complete, accurate and prepared in accordance with completion instructions issued by the HKMA. While there is no requirement for the auditor to opine on the AI's books and records under section 63(3A), the auditor should remain professionally skeptical and stay vigilant to matters concerning the quality of the AIs' books and records identified during the course of its work that may impact the banking returns and other information submitted by the AI to the HKMA. In this connection, the auditor should exercise judgement in determining the controls that fall into the scope of reporting under section 63(3A)(a)(i) according to the specific circumstances of individual AI. It should also 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

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<sup>7</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

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 the auditor 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, including controls over the data and information from the AI's overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation where such data and information are material to the group. 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.
- The auditor 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
- In situations where the AI has revised the returns and filed them with the HKMA, the nature and extent of changes made between the originally submitted returns and the Relevant Returns, may provide an indication of the strength or weakness of the controls over the compilation of returns. The auditor should take these into account in assessing the effectiveness of such controls.

*b. Understanding of the return compilation process and requirements*

- Persons responsible for compilation of returns from the AI's books and records should 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 that documents the relevant compilation processes at an appropriate level of detail provides a reference to officers responsible for the compilation process of 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. The procedures manual should contain details that are consistent with guidelines, instructions from the HKMA and relevant correspondence between the AI and the HKMA which relate to compilation of returns and information.
- A comprehensive and quality procedure manual is indicative of management demonstrating an adequate understanding of the relevant reporting requirements and the controls necessary to ensure proper compilation of returns and information from books and records. The auditor should evaluate the adequacy of such a procedure manual as part of understanding an AI's controls in relation to the compilation process.
- The reporting requirements as set out in banking returns completion instructions can be complex and many aspects of the requirements are subject to proper interpretation. For certain specialist areas the auditor may need to consider engaging relevant subject matter experts (e.g. financial risk and valuation experts) to assist in assessing the appropriateness of an AI's interpretation and application of relevant completion instructions.

- The auditor 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. The auditor would also check the documentation of the control systems, and clarify the understanding of the systems with management to confirm the systems operate in the manner documented. The auditor is generally expected to perform tests on the effectiveness of these control systems and evaluate whether the governance framework as well as the roles and responsibilities with regard to compilation of banking returns are properly defined, documented and executed by the AI.

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.
- The auditor would carry out procedures to examine such documentation and perform tests as to whether the information contained in the completed returns and other information are compiled from the underlying books and records and seek appropriate explanations on any material exceptions or discrepancies thereon from management.
- If a Relevant Return has been revised, the auditor should obtain a reconciliation of adjustments between the originally submitted return and the Relevant Return from management. Such a reconciliation should contain the information as set out in Part A of Appendix 9 of this PN. Obtaining an understanding of the nature of the reconciling items and the reasons for such adjustments for the purpose of determining whether additional work procedures, based on the auditor's judgement, would be necessary for the planning of the engagement.

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.
- The auditor 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.
- The auditor 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*

- 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 tools or systems to facilitate or automate the compilation of returns and other information, the auditor would consider relevant procedures to ensure the reliability of outputs generated from such computer-based tools or systems. These procedures may include assessing the adequacy of relevant controls (such as system production and change management controls, access security controls, end-user computing tools management controls and system backup management controls) over such tools or systems, or validating the data extraction performed by such tools or systems with the reporting requirements set out in the relevant rules and completion instructions, as appropriate. The auditor may also consider involving relevant IT experts in supporting the performance of the above procedures as circumstances warrant.
- In the event where the computer-based tools or systems to process information used for compiling returns and other information are not maintained by the AI (e.g. an AI may be a branch of an overseas incorporated bank which relies on the computer-based tools or systems developed and maintained by its head office), the auditor should perform relevant procedures to ensure the reliability of outputs generated from such computer-based tools or systems. These may include evaluating the user acceptance tests conducted before the launch or update of the systems or tools, reviewing issues/incidents log in relation to such systems or tools and reviewing rectification of issues/incidents relevant to the accuracy and completeness of information reported in the banking returns that may indicate any reliability issues with such systems or tools, or validating the data extraction performed by such tools or systems with the reporting requirements set out in the relevant rules and completion instructions, as appropriate.

*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.
- The auditor 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**

82. 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, the auditor will be asked particularly to report on those controls relevant to the duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB (section 63(3A)(a)(ii)) of the Ordinance. To meet this reporting requirement, the auditor would identify whether appropriate control procedures are in place to enable the AI to comply with its statutory duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB of the Ordinance and test whether such control procedures, including controls over the data and information from the AI's overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation where such data and information are material to the group, are operating effectively.
83. 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.
84. Part XII of the Ordinance deals with the requirements to disclose information to the HKMA, and the auditor's reporting responsibilities in this regard are addressed in the work on examining the AI's control systems for the correct compilation of returns or information from the books and records.
85. A report for the purpose of section 63(3A) also requires the auditor to conclude on whether adequate controls are in place to enable compliance with the following provisions of the Ordinance:
- Part XV – Limitations on exposures and interests of AIs
  - Part XVIA – Capital requirements (for locally incorporated AIs only)
  - Part XVIB – Liquidity requirements
86. The types of controls which are normally in place in the AI to enable compliance with the above provisions and which the auditor would take into account in designing the procedures include:
- a. *Part XV – Limitations on exposures and interests of AIs*
- Written policy in respect of taking of own shares as security, large exposures and advances to connected parties, equity exposures and interests in land;
  - Establishment of appropriate internal limits (within the statutory limits under the Ordinance and limits under the Banking (Exposure Limits) Rules ("BELR") for individual customers and groups of related customers, equity exposures and interests in land and sub-limits for various business units, branches or subsidiaries; *(With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions*



*was repealed. The BELR on equity exposures have come into effect on 13 July 2018. Please refer to BELR for the details of requirements.)*

- 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 XVIA – Capital requirements (for locally incorporated AIs only)*
- Written policy on the AI's strategy on maintaining capital adequacy and leverage ratio requirement for the purpose of both its business activities and to meet regulatory requirements;
  - Establishment of target capital ratios and leverage ratio 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 and leverage ratio requirements and changes in capital adequacy and leverage ratio requirement as a result of projected asset mix, balance sheet growth and capital resources;
  - Capital adequacy ratios, Net CET1 capital ratio and buffer level, and leverage ratio 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 and leverage ratio requirement prior to the transaction taking place;
  - Stress-tests are performed on capital adequacy ratio on a regular basis.
- c. Part XVIB – Liquidity requirements*
- Written policy on the AI's strategy and procedures for maintaining adequate liquidity at all times to meet business and regulatory requirements;
  - Category 1 institutions should have systems and procedures in place to:
    - ensure on an ongoing basis that the assets included as high quality liquid assets ("HQLAs") for the purpose of calculating the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR") satisfy all requirements relating to asset class, characteristics and operational requirements as specified in Schedules 2 to 4, where applicable of the Banking (Liquidity) Rules;
    - manage its HQLAs and related risks (including foreign exchange risk and concentration risk) on an ongoing basis;

- ensure proper review and application of established methodologies (including key management assumptions) in determining the amounts of certain expected cash flow items (such as "operational deposits", potential drawdown on undrawn committed facilities and non-contractual contingent funding obligations) for the calculation of LCR and NSFR;
  - Category 2 institutions should have systems and procedures in place to:
    - conduct ongoing assessment and management of its liquefiable assets and related risks to ensure each asset included in the liquefiable assets and satisfies all the applicable requirements of Part 8 of the Banking (Liquidity) Rules; and
    - conduct ongoing assessment and management of its Core Funding Ratio ("CFR") and related risks introduced in liquidity regulations in January 2018 applicable to AIs designated by the HKMA as "category 2A institutions" in accordance with Rule 3A of the Banking (Liquidity) Rules.
  - Systems, controls and procedures are in place to ensure that the valuation of any asset, liability, off-balance sheet item or cash flow measured at fair value is prudent and reliable for the purposes of calculating the LCR or Liquidity Maintenance Ratio ("LMR"), and NSFR or CFR (as applicable);
  - Target ratios for liquidity which are above the minimum regulatory requirements are set (i.e. the liquidity requirements of LCR (or LMR) and NSFR (or CFR) under rule 4 (or rule 7) and rule 8A (or rule 8D) of the Banking (Liquidity) Rules respectively) for different categories of institutions and procedures are in place to identify and immediately report breaches or exceptions to senior management;
  - Procedures are in place to allow liquidity 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.
87. A checklist of questions concerning compliance with Part XII, XV, XVIA or XVIB of the Ordinance is set out in Appendix 7 to this PN.
88. Other procedures that the auditor may consider in assessing controls to ensure compliance with Parts XV, XVIA and XVIB are set out in the HKMA's Supervisory Policy Manual IC-3<sup>8</sup>, Annex B.

### **Maintenance of adequate provision**

89. For locally incorporated AIs only, the auditor is 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.

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<sup>8</sup> As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

90. 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.
91. The auditor, 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 the statutory reporting duties under this section may be an extension of the work performed for statutory audit purposes.
92. The types of controls AIs would normally maintain to ensure that they meet the objective of maintaining adequate provision in accordance with the Hong Kong Financial Reporting Standards and, if any, the additional requirements from the HKMA 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.
  - 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**

93. The auditor would follow the guidance in HKSA 580, "Written Representations" 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 auditor 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 auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondence with the HKMA, etc.) for the purpose of the auditor's examination of the internal control systems, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
  - 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 laws and regulations or deficiencies in internal control systems and procedures and financial 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, XVIA (for locally incorporated AIs only) or XVIB 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 131 to 139);
  - 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 auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report.
94. An example management representation letter is set out in Appendix 2 to this PN – Example 2.

### **Materiality**

95. 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.
96. The auditor would need to assess whether an exception identified from testing controls represents a control weakness or is a result of an isolated incident. The auditor should gather sufficient evidence to determine whether a control weakness exists and then proceed to assess whether such weakness is material.

97. The auditor exercises judgment on whether a weakness or failure in the control systems is material by evaluating the impact such a weakness or failure has on the banking returns or other 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. The auditor should also consider whether or not the control weakness is pervasive. That is, whether it has led to, or in the future will likely result in, one or more material errors in the banking returns or other information.
98. 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. The auditor would perform adequate procedures to confirm existence and effectiveness of controls on areas which, in the auditor's judgment, are material with respect to the AI.
99. The auditor 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 (whether material or not) identified in the course of the auditor's 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, the auditor would consider carefully the underlying reasons leading to such errors and assess the implications on the work under section 63(3A). A systematic error as well as numerous unrelated errors identified in respect of a specific return should provide an indication that weaknesses exist in the AI's ability to measure and capture data and information from books and records correctly. Even if such errors are not material for reporting under section 63(3) of the Ordinance, they call into question the soundness of AI's internal controls over regulatory reporting process and hence should be considered by the auditor for reporting under section 63(3A) of the Ordinance. The same consideration should be equally applied when the auditor evaluates other information reported to the HKMA by the AIs.

## Reporting

100. The auditor's 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 auditor's report under section 63(3A) is structured into two main parts. The first part is a reasonable assurance 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, XVIA (for locally incorporated AIs only) and XVIB 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 a limited assurance 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 auditor was aware of:

- any instances where the AI has materially contravened any of its duties under Part XII, XV, XVIA (for locally incorporated AIs only) or XVIB 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.

101. 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 the auditor to take into account any other information which comes to the attention in the capacity as the auditor of the AI, including any information obtained from the normal course of any audit work performed and in the auditor's examination of specific returns under section 63(3).
102. An appropriate description of any weakness or failure in the control systems considered to be material would be reported together with the auditor's recommendations for improvement where possible. In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised), Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised). In the event that observations are identified in relation to AI's control systems during the course of auditor's work but do not result in modification of the auditor's report under section 63(3A) of the Ordinance, the auditor may consider communicating these control observations to AI's management and those charged with governance as the auditor deems appropriate.
103. The auditor should carry out an engagement in accordance with HKSAE 3000 (Revised) and with reference to this PN. The auditor's 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. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 (Revised) and with reference to PN 830 (Revised). The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within three months from the end of the specified period and the AI would forward the auditor's report together with any comments thereon within a further one month.
104. Examples of auditor's reports under section 63(3A) are set out in Appendix 1 to this PN – Examples 3 and 4. An example of a modified auditor's report is set out in Appendix 8 to this PN – Example 2.

## **Ad hoc reports under section 59(2)**

### **General**

105. The HKMA has discretionary power under section 59(2) to require an AI, after consultation with the AI, to provide an auditor's 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 the auditor to report on internal controls, specific transactions, or any other matters which are relevant for the performance of its functions under the Ordinance.
106. 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 auditor;
  - 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.

107. 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 auditor was, or is likely to be, deficient.
108. The AI's statutory auditor may be appointed for the purposes of reporting under section 59(2). Even where there are no doubts about the capability of the statutory auditor, the HKMA has the right to require that a report under section 59(2) be obtained from another audit firm to obtain a fresh perspective on matters which are the subject of the report. The appointed auditor must also be able to meet the ethical and independence requirements set out by the internationally accepted ethical and independence standards (such as the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants) and the additional requirements (if any) set out by the HKMA in relation to the relevant engagement before its formal acceptance of the appointment.
109. The extent of the detail included in the auditor's 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 auditor. The auditor would have regard to the expectations of the HKMA and the AI and would evaluate the risk of misinterpretation or misunderstanding in this regard.
110. The auditor 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

111. 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 auditor 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.
112. 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 auditor to cover in the ad hoc review;
  - Specific guidelines on format of deliverables, including level of assurance required from the auditor.
113. 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 auditor would determine whether the auditor's report is intended to reflect the position before, after or during the change period.

114. In certain circumstances, the auditor 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 auditor is not the AI's statutory auditor or the scope relates to an area that is not covered extensively by statutory audit work. In these circumstances, the auditor 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 auditor to assist the HKMA in refining the scope more effectively.
115. Where applicable, the auditor would agree with the HKMA and the AI on which of the AI's legal entities, divisions, or businesses the report would cover. Depending on individual circumstances, the auditor would usually engage the HKMA in a formal discussion in the presence of the AI's management (i.e. a tri-partite arrangement) to confirm expectations as to the scope, nature and extent of work to be performed prior to commencement of the section 59(2) engagement. In the event changes need to be made to scope, nature and extent of work subsequent to the commencement of engagement, such changes should be communicated and agreed with the AI and the HKMA on a timely basis .
116. The auditor's 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 auditor concerned.

#### **Nature of work**

117. The work that the auditor performs 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 or others (e.g. review and comment engagement).
118. For reasonable or limited assurance engagement, the auditor should consider to conduct the work in accordance with HKSAE 3000 (Revised). The auditor 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 agreed-upon procedures engagement, the auditor should perform the engagement under HKSRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information".
119. Paragraph 118 only provides reference for the auditor and it is not served to limit the appointed auditor's professional judgment and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

#### **Materiality**

120. Given the varying nature of ad hoc reviews under section 59(2), the auditor 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.



121. In order to assess fully the level of assurance that is appropriate concerning general, qualitative, subjective terms of reference, the auditor, 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

122. The auditor 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).
123. 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.
124. 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 auditor 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).
125. The description of the procedures undertaken includes, where appropriate, such matters as details of documents examined, persons interviewed and tests of detail performed.
126. The auditor would attach a copy of the engagement letter and the Letter of Instruction from the AI as appendices to the auditor's report.
127. 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)

128. Under section 59A(2)(c), the auditor of an AI appointed under section 395, 396, 397 or 398 of the Companies Ordinance is required to provide written notice to the HKMA if the auditor decides to include in the audit report on the AI's financial statements any qualification or adverse statement as to a matter mentioned in section 406 or 407 of the Companies Ordinance.
129. The issue of a qualified audit report or an adverse statement in relation to a matter under section 406 or 407 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, the auditor would normally be expected to discuss with the AI any matter about which the auditor is concerned, and request that the AI draws the matter to the attention of the HKMA. Nevertheless, it is important for the auditor to strike a balance between preserving the 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 auditor would take into account the severity of the matter as well as the AI's response to the auditor's request to communicate the matter to the HKMA.

130. 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 auditor should report directly to the HKMA after considering appropriate independent legal advice. The auditor would make reference to these examples in assessing the circumstances surrounding the qualification of the audit report on an AI's financial statements or an adverse statement in connection with a matter under section 406 or 407 of the Companies Ordinance.

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

131. Sections 63A and 63B require AI's auditor to submit a report to the HKMA if the auditor becomes aware of any matter in the course of performing the duties as the auditor that in the auditor's 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).
132. Matters which are required to be reported under sections 63A and 63B have to be reported by the auditor 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 auditor is of the opinion that the matter should be reported.
133. Section 63A requires the auditor which is appointed under section 59(2), 63(3) or 63(3A) of the Ordinance or section 395, 396, 397 or 398 of the Companies Ordinance to report to the HKMA if the auditor becomes aware of a matter which, in the auditor's opinion, adversely affects the financial position of an AI to a material extent. The auditor would consider any such matter which comes to the auditor's 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.
134. 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.
135. As matters which are reportable under section 63A relate to the financial position of AIs, the auditor is expected to take into consideration potential issues that may constitute a reportable matter under this section in the course of performing the work on AI's financial statements or for the purpose of reporting under section 59(2), 63(3) or 63(3A).
136. Under section 63B, when the auditor becomes aware of a matter that, in the auditor's 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"), the auditor shall, as soon as practicable after the auditor becomes aware of the matter, submit to the HKMA a report in writing on the matter.

137. A reportable matter in respect of AIs refers to a matter that, in the auditor's 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.
138. The HKMA has recognized that there is no obligation for the auditor to specifically perform work or to change the scope, nature and depth of the 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 the auditor is not required to actively seek out grounds for making a report under section 63B and it is only when the auditor becomes aware, in the ordinary course of the work, of a reportable matter that the auditor would make a report to the HKMA.
139. A summary of the relevant regulations and requirements issued by the SFC that the auditor would have to be familiar with for the purpose of understanding and fulfilling the duties under section 63B is set out in Appendix 6 to this PN.

### **Notification of resignation of the auditor under section 59A(2)**

140. Section 59A(2) requires the auditor of AIs appointed under section 395, 396, 397 or 398 of the Companies Ordinance to provide written notice to the HKMA if the auditor resigns before the expiration of the term of office (section 59A(2)(a)) or if the auditor does 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**

141. In an application for voluntary revocation of the authorization of an AI, the HKMA would require the AI to furnish a report by its auditor 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).
142. A report by the auditor of factual findings in relation to a voluntary revocation of the authorization of an AI is an agreed-upon procedures engagement. As the auditor simply provides 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 auditor and draw their own conclusions from the auditor's 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.
143. The report of factual findings by the auditor 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 customer deposit records of the AI as at a specified date, and whether this is consistent with the information in 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 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.
144. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from director (or management) confirming, inter alia, the following areas as at the specified date for the purpose of the report:
- a. the accuracy and completeness of third party deposit liabilities of the AI;
  - b. the balance sheet was in agreement with the AI's books and records; and
  - c. the accuracy and completeness of contingent liabilities and outstanding commitments.
145. An example management representation letter is set out in Appendix 2 to this PN – Example 3.
146. 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 THE AUDITOR ON COMMUNICATIONS WITH THE HKMA**

147. Section 61 permits the auditor, notwithstanding any duty which the auditor may owe to the 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 the auditor becomes aware in the capacity of the auditor and which is relevant to any function of the HKMA under the Ordinance.
148. The protection covers not only the auditor appointed under section 395, 396, 397 or 398 of the Companies Ordinance but also the auditor appointed for the purpose of sections 50(1)(c), 59(2), 63(3) and 63(3A). It also covers the auditor who makes a report to the HKMA under sections 63A and 63B.
149. 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 auditor in the capacity as the auditor of an AI, they may communicate that information to the HKMA notwithstanding that:
- the information does not relate to the auditing work undertaken by the auditor; or
  - the source of the information was not the AI.
150. Section 61 does not of itself require the auditor to change the scope, nature and depth of the audit work and the auditor is not required to actively seek out grounds for making a report under this section.
151. Appendix 4 to this PN contains further guidance on ad hoc reports under section 61 that has been prepared to assist the auditor in understanding the circumstances in which the auditor 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 auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

### **EFFECTIVE DATE AND TRANSITION**

152. Effective for reporting periods ending on or after 1 January 2019.
153. Auditor's reports for reporting periods ending before the above-mentioned effective date should continue to be prepared with reference to the guidance set out in the previous version of this PN.

## APPENDIX 1 Examples of reports by the auditor

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

#### INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3) OF THE BANKING ORDINANCE

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. 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 on an unconsolidated basis*]\* [*Institution's offices in Hong Kong*]\* for the month of [month/year]; and
- iv. Parts I - IV 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:]\*

#### Directors' Responsibilities

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.

#### Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1<sup>9</sup> and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

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<sup>9</sup> HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

*Auditor's Responsibilities*

Our responsibility is 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.<sup>10</sup> These procedures do not represent an audit of the books and records of the Institution.

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

We have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised), which included examining evidence obtained from the Institution regarding the Institution's compilation of banking returns and other information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

*Opinion*

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.

*Intended Users and Purpose*

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Auditor's Address]  
[Date]

\* Delete where not applicable

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<sup>10</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

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

**INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3) OF THE BANKING ORDINANCE**

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. 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*].

*Chief Executive's Responsibilities*

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.

*Our Independence and Quality Control*

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1<sup>11</sup> and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

*Auditor's Responsibilities*

Our responsibility is 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.<sup>12</sup> These procedures do not represent an audit of the books and records of the Institution.

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<sup>11</sup> HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>12</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".



We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

We have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised), which included examining evidence obtained from the Institution regarding the Institution's compilation of banking returns and other information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

*Opinion*

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.

*Intended Users and Purpose*

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's Address]

[Date]

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

**INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3A) OF THE BANKING ORDINANCE**

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, XVIA and XVIB 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, XVIA and XVIB 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.

*Directors' Responsibilities*

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 from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVIA and XVIB 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.

*Our Independence and Quality Control*

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1<sup>13</sup> and accordingly maintains a

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<sup>13</sup> HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

*Auditor's Responsibilities*

Our responsibility is 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.<sup>14</sup>

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving conclusion 1 and obtain limited assurance for giving conclusion 2 below.

In respect of our examination of relevant internal control systems for conclusion 1 below, 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.

In respect of conclusion 2 below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised). The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

*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, in all material respects, during the relevant period, 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
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, XVIA or XVIB of the Ordinance;

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<sup>14</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

- 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.

*Intended Users and Purpose*

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Auditor's Address]  
[Date]

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- \* *For the conclusion section (1), the above example would be adopted for the situation where the auditor has no reservations about the institution's systems of internal control [an unqualified opinion]. Example modified conclusions are set out in Appendix 8 to this Practice Note.*

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

**INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3A) OF THE BANKING ORDINANCE**

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 XVIB 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 XVIB of the Ordinance.

*Chief Executive's Responsibilities*

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 from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV and XVIB of the Ordinance.

*Our Independence and Quality Control*

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1<sup>15</sup> and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

*Auditor's Responsibilities*

Our responsibility is 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.<sup>16</sup>

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<sup>15</sup> HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>16</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving conclusion 1 and obtain limited assurance for giving conclusion 2 below.

In respect of our examination of relevant internal control systems for conclusion 1 below, 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.

In respect of conclusion 2 below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised). The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

#### *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, in all material respects, during the relevant period, 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
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 XVIB of the Ordinance.

#### *Intended Users and Purpose*

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's Address]

[Date]

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\* For the conclusion section (1), the above example would be adopted for situation where the auditor has no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion]. Example modified conclusions are set out in Appendix 8 to this Practice Note.

**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.*

**INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 59(2) OF THE BANKING ORDINANCE**

To [Appropriate Addressee] of 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 an engagement 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 engagement 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]\**

*Directors' Responsibilities*

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.

*Our Independence and Quality Control*

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1<sup>17</sup> and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

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<sup>17</sup> HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

*Auditor's Responsibilities*

Our responsibility is to perform an engagement 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; and
- b. *[set out responsibilities for other specified areas of review as appropriate]\*.*

based on the results of the procedures performed by us.<sup>18</sup>

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the 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. We have planned and performed our work to obtain limited assurance for giving conclusion 1 below.

A limited assurance engagement undertaken in respect of our conclusion 1 below, in accordance with HKSAE 3000 (Revised) involves [level of detail about procedures to be determined by the auditor]. The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

In respect of *[other specified areas of review]*, [our engagement was conducted in accordance with *[Hong Kong Standard on Assurance Engagements 3000 (Revised)]\* [Hong Kong Standard on Related Services 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information]\** and with reference to PN 830 (Revised) issued by the HKICPA.]<sup>19</sup>

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.

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<sup>18</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

<sup>19</sup> This is for reference only and is not served to limit the appointed auditor's professional judgement and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.



*Conclusion*

Based on the foregoing, [with the exception of the matters set out in the findings and recommendations arising from our review of the internal control systems set out in Appendix [ ] to this report ]<sup>20</sup>:

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*].

*Intended Users and Purpose*

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. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[*Auditor's Address*]  
[*Date*]

\* *Delete where not appropriate*

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<sup>20</sup> In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised). Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).

**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*]\***

To [Appropriate Addressee] of XYZ 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 from the management the balance sheet of the Institution as at [*date*] and agreed to the books and records of the Institution as at [*date*].
3. We obtained from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [*date*] and compared it to the books and records.
4. For the contingent liabilities and outstanding commitments, we also obtained and reviewed the minutes of the Board of Directors ("Board Minutes") for the period from [*date*] to [*date*].
5. We obtained a Representation Letter from the Board of Directors confirming the following:
  - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [*date*];
  - b. the balance sheet as at [*date*] agreed with the books and records of the Institution;
  - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [*date*].

We report our findings as follows:

- a. With respect to item 1, we found there were no third party customer deposit liabilities as attached as at [*date*], and this was consistent with the information in the Representation Letter.
- b. With respect to item 2, we found the attached balance sheet as at [*date*] was in agreement with the books and records of the Institution as at [*date*], and was consistent with the information in 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 Representation Letter.
- d. With respect to item 4, we were not aware of any inconsistency of the information in the Board Minutes.

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 distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
[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 Auditor's report]*

Dear Sirs

This representation letter is provided 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, columns 1 - 5 of the *[consolidated]\** Return of Large Exposures of the *[Bank / Company / Branch]\** for the quarter ended *[date]*;
- iii) 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 that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

#### *The Returns*

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting and non-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. There have been no contraventions by the *[Bank / Company / Branch]\** of any of its duties under Part XII, XV, *[XVIA]\** *[applicable to locally incorporated AIs only]* or XVIB of the Banking Ordinance during the period from *[date]* to *[date]* or which were the subject of correspondence during this period.
3. We are not aware of any matter which adversely affects the financial position of the *[Bank / Company / Branch]\** to a material extent.
4. *[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.
5. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.
6. All the Returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the Monetary Authority.

*Information Provided*

7. All the returns provided to you for the purpose of this engagement are the ones submitted to the Monetary Authority on the following dates (Note: Specify the dates of submission for respective returns which are within the scope of section 63(3) reporting).
8. All transactions undertaken by the [Bank / Company / Branch]\* have been properly reflected and recorded in the accounting and non-accounting records.
9. All of the following information has been made available to you for the purposes of performing your procedures on the Returns:
  - i) All accounting and non-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;
  - vi) Other information which may be relevant to the preparation of the Returns; and
  - vii) Unrestricted access to persons within the [Bank / Company / Branch]\* from whom you determine it necessary to obtain audit evidence.
10. We have disclosed to you all communications between the [Bank / Company / Branch]\* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the information presented in the Returns.
11. We have communicated to you all deficiencies in internal control of which we are aware of that could have a material effect on the information presented in the Returns.

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 Auditor's report]*

Dear Sirs

This representation letter is provided 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, *[XVIA]\* [applicable to locally incorporated AIs only]* and XVIB 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 that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

*Internal Control Systems*

1. We have fulfilled our responsibilities for establishing and maintaining adequate internal control systems.
2. There were no 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.
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. There have been no contraventions by the *[Bank / Company / Branch]\** of any of its duties under Part XII, XV, *[XVIA]\* [applicable to locally incorporated AIs only]* or XVIB of the Banking Ordinance during the period from *[date]* to *[date]*.
5. The *[Bank / Company]\** has maintained at all times during the review period 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]*.
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 have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

*Information Provided*

9. 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 and non-accounting records;
  - iv) Any other necessary information; and
  - v) Unrestricted access to persons within the [Bank / Company / Branch]\* from whom you determine it necessary to obtain audit evidence.
10. We have disclosed to you all material weaknesses in the internal control systems of which we are aware and also those areas for which management believes the cost of corrective action may exceed the benefits.
11. We have disclosed to you any irregularities involving management or employees who have significant roles in the systems of internal control.
12. We have disclosed to you all communications between the [Bank / Company / Branch]\* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the banking returns.
13. There are no other records or related information, including significant matters addressed and resolutions adopted at any [directors'/management] meetings for which minutes have yet to be finalised, which have not either been brought to your attention or provided to you.

Yours faithfully`

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

---

Director\*/Chief Executive\*

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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

This representation letter is provided in connection with your performance of the agreed-upon procedures in respect of the voluntary revocation of the authorization of the *[Bank / Company / Branch]\**.

We confirm that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

*Financial Statements*

1. We have fulfilled our responsibilities 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 the following:
  - (a) As at *[date]*, the third party deposit liabilities of the *[Bank / Company / Branch]\** are accurate and complete;
  - (b) As at *[date]*, the *[Bank / Company / Branch]\** 's balance sheet agrees with the books and 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]*, there are no other outstanding commitments or contingent liabilities 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. The summary of contingent liabilities and outstanding commitments are accurate and complete.

*Information Provided*

3. All transactions undertaken by the *[Bank / Company / Branch]\** have been properly reflected and recorded in the accounting records.
4. 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 the auditor 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 the individual auditor and client. The auditor may consider it appropriate to include a limitation of liability clause in the engagement letter in accordance with the auditor's 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

#### Objective of services

- 1.1 You have requested that we report on certain returns and systems of control of XYZ Bank (the "Institution") under section 63(3) and (3A) of the Banking Ordinance (the "Ordinance"). The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our expressing a conclusion on the returns and systems of control.

#### Responsibilities of the directors

- 2.1 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.

- 2.2 Reporting under Section 63(3) of the Ordinance

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.

- 2.3 Reporting under section 63(3A) of the Ordinance

It is the directors' responsibility to establish and maintain adequate internal control systems to enable:

- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii) the Institution to comply with its duties under Parts XII, XV, XVIA and XVIB 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.

- 2.4 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 2.3 above and paragraphs 3.2 and 4.3 below.

### Responsibilities of the auditor

#### 3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor 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. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

#### 3.2 Reporting under section 63(3A) of the Ordinance

- i) Our duty as auditor 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.
- ii) In addition, our duty as auditor 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, XVIA or XVIB 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.

The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

### Scope of work

- 4.1 The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date].
- 4.2 Reporting under Section 63(3) of the Ordinance
- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures that we will perform to enable us to form our opinion will also 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. 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.

- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.
- iii) 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.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) and with reference to Practice Note 830 (Revised) issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also 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.
- ii) 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.

4.4 As part of our procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the engagements on matters having a material effect.

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution rests with you, 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. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 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]*

**Agreement of terms**

5.1 Once it has been agreed, this letter will remain effective, from one appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our report under section 63(3) and 63(3A) of the Ordinance including our respective responsibilities.

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

**Objective of services**

1.1 You have requested that we report on certain returns and systems of control of XYZ Bank's Hong Kong Branch (the "Institution") under section 63(3) and (3A) of the Banking Ordinance (the "Ordinance"). The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our expressing a conclusion on the returns and systems of control.

**Responsibilities of management**

2.1 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.

2.2 Reporting under Section 63(3) of the Ordinance

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.

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

It is management's responsibility to establish and maintain adequate internal control systems to enable:

- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii) the Institution to comply with its duties under Parts XII, XV and XVIB of the Ordinance.

2.4 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 2.3 above and paragraphs 3.2 and 4.3 below.

## Responsibilities of the auditor

### 3.1 Reporting under section 63(3) of the Ordinance

Our duty as auditor 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. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

### 3.2 Reporting under section 63(3A) of the Ordinance

- i) Our duty as auditor 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.
- ii) In addition, our duty as auditor 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 XVII of the Ordinance.

The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

## Scope of work

4.1 The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [date].

### 4.2 Reporting under Section 63(3) of the Ordinance

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures that we will perform to enable us to form our opinion will also 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. 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.
- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.

- iii) 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.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) and with reference to Practice Note 830 (Revised) issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also 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.
- ii) 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.

4.4 As part of our procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the engagements on matters having a material effect.

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution and XYZ Bank rests with you, 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. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 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]*

**Agreement of terms**

5.1 Once it has been agreed, this letter will remain effective, from one appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our report under section 63(3) and 63(3A) of the Ordinance including our respective responsibilities.

Yours faithfully

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

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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

**Objective of services**

- 1.1 You have requested that we 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]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our reporting the factual findings.

**Scope of work**

- 2.1 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.
- 2.2 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 from the management the balance sheet of the Institution as at [date] and agree to the books and records of the Institution as at [date].
  - iii) Obtain from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [date] and compare it to the books and records.
  - iv) For the contingent liabilities and outstanding commitments, obtain and review the minutes of the Board of Directors for the period from [date] to [date].
  - v) With respect to (i) – (iii) above, we will also obtain a Representation Letter from the Board of Directors confirming the following:
    - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [date];
    - b. the balance sheet as at [date] agreed with the books and records of the Institution;
    - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [date].
- 2.3 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 distributed to any other party or used by anyone else or for



any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

- 2.4 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]*

**Agreement of terms**

- 3.1 We shall be grateful if you could confirm in writing your agreement to the terms of this letter by signing and returning the attached copy, or let us know if they are not in accordance with your understanding of our terms of appointment.

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 the auditor in understanding the circumstances in which the auditor 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 auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.*

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

#### **The auditor**

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 the auditor is 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 the 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 the auditor, 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 the auditor may communicate a matter to the HKMA with the protection of section 61 regardless of the source of that information, provided the auditor becomes aware of the matter in the capacity as the auditor of that client AI.
2. Confidentiality is generally either an implied or explicit term of the auditor's contracts with the clients, but in section 61 circumstances it does not prevail since the auditor is 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.
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. The auditor cannot, however, be expected to be aware of all circumstances which, had the auditor known of them, would have led the auditor to exercise the right to report under section 61. That section does not require the auditor to change the scope of the audit work, nor the frequency or timing of the audit visits. The auditor does not have an obligation to seek out grounds for making a report under section 61; the section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover an occurrence of the kind described in paragraph 10 of this Appendix. It is only when the auditor becomes aware in the ordinary course of the audit work of such an occurrence that the auditor would make detailed enquiries with section 61 specifically in mind.
6. The HKMA recognizes that it would not be appropriate for the auditor to report to it information which the auditor has obtained through the 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. The auditor would realize that there are circumstances in which section 61 will not provide protection, for example, where the auditor 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 auditor's action in reporting to the HKMA. The auditor 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 the report are such as to secure the protection of section 61 and that it only includes relevant material. However, the auditor 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 auditor fails 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 the auditor is to the auditor only; the auditor is not free to pass that information to others, such as the 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 auditor:
- a. when it believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of the audit or other report or the way in which the auditor carries out the 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 auditor is not informed by the HKMA of any such matter, the auditor is entitled to assume that the HKMA has no such disclosure to make. Accordingly, there is no need for the auditor to request the HKMA to confirm this.

### **Taking the initiative**

10. The HKICPA has developed a criterion for use by the auditor in deciding whether to take the initiative in making an ad hoc report in addition to the regular reporting responsibilities. The criterion is that the auditor would take the initiative when the auditor considers 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 auditor's 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 was aware of it.
11. As stated in paragraph 5 of this Appendix, the auditor is not required to seek out grounds for making a report. It is only where the auditor becomes aware during the ordinary course of the work that the criterion might be satisfied that the auditor would take the matter further.

### Reporting via the AI

12. It is important for the auditor to act in a manner that will preserve the professional relationship with the client. Normally, therefore, the auditor would ask the AI to draw matters about which the auditor is 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 auditor 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 auditor 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 auditor has 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 auditor forms 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 auditor forms 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 auditor 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 auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where the auditor believes 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 auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g. where the auditor has 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 auditor 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 auditor 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 auditor becomes aware of a matter which in the professional judgment the auditor considers ought to be reported to the HKMA, the auditor would consider adopting the following procedures, bearing in mind that speed may be of the essence:

- a. The auditor would consider the facts and, unless inappropriate in the circumstances, discuss the matter with the management of the AI.
- b. In normal circumstances, the auditor 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 auditor would write to the AI setting out the views and requesting the directors or management to inform the HKMA of the matter, within a specified period of time. The auditor 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 auditor to report the matter directly to the HKMA, and to inform the management of the AI of the contents of the 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 auditor would report directly 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 auditor 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 auditor 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 auditor to report directly to the HKMA.

In exceptional circumstances where the auditor feels 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 auditor would make an appropriate written or other report direct to the HKMA after considering the appropriateness of taking independent legal advice.

17. The auditor would have to satisfy themselves that the decision will stand up to examination at a future date on the basis of the following considerations:

- what the auditor knew at the time;
- what the auditor should have known in the course of the audit or investigatory work;
- what the auditor should have concluded; and
- what the auditor 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 auditor reasonably can after forming the view that it is expedient to do so in order to protect the interests of depositors. For the auditor this may well mean ensuring that an ad hoc report is made to the HKMA in advance of making the report after considering the appropriateness of taking independent legal advice.

19. The auditor 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 the auditor's responsibilities. An example of this would be the auditor considering the implications of the ad hoc report for the auditor's opinion on the financial statements.

20. To ensure that the HKMA is informed promptly of matters which meet the criterion, a firm acting as the auditor or reporting accountant 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 the work, is passed on to the partner responsible without unnecessary delay.

## APPENDIX 5

### The Banking Ordinance – Important provisions for the auditor

*This list is based on the Banking Ordinance which was effective as at 31 July 2018. 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 auditor 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 auditor's report on returns or information on an overseas branch of an AI incorporated in Hong Kong.
- 63(3) The MA can require an auditor's 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 the auditor on certain internal control systems.
- 63(3A) The MA can request recurring annual reports by the auditor on certain internal control systems and other matters.

##### **Notification in respect of the auditor**

- 59A(1) Requirement for an AI incorporated in Hong Kong to notify the MA with respect to proposed or actual changes of the auditor.
- 59A(2) Requirement for an auditor of an AI appointed under section 395, 396, 397 or 398 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 the auditor with the MA**

- 61 Ability of the auditor 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 the auditor to provide information etc. to competent persons.



## APPENDIX 6

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

*This summary is based on the Securities and Futures Ordinance and its subsidiary legislation which were effective as at 31 July 2018. 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 the auditor

*This checklist has been prepared for the guidance of the auditor who is required to report on compliance with Parts XII, XV, XVIA and XVIB of the Banking Ordinance based on the Banking Ordinance which was effective as at 31 July 2018. 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 issued shares ;
- 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 Exposures 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.*
- 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 Part 1 section 2 of 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). With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions was repealed. The Banking (Exposure Limits) Rules ("BELR") on equity exposures have come into effect on 13 July 2018. Please refer to BELR for the details of requirements.*
  - *exposure to a multilateral development bank as defined in Part 1 section 2 of 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 equity exposures**

- BELR 10,11 Has the AI complied with the requirement that its equity exposure ratio does not exceed 25 % at all times, subject to any variation served on the AI by the HKMA?

- BELR 12 In calculating the equity exposure ratio, has the AI correctly calculated its aggregate equity exposures, taking into account relevant rules relating to aggregation of exposures arising from its banking and trading book, offsetting and treatment of net short position in an equity exposure?

- BELR 13 In calculating the equity exposure ratio, has the AI correctly excluded the following interests which are not taken into account for calculating the institution's equity exposure ratio:

- a. holding of any share capital that is held as security for facilities granted by the AI;
- b. holding of any share capital that is acquired in the course of satisfaction of debts due to the AI. In any event, such acquisitions must be disposed at the earliest suitable opportunity, or within 18 months unless the HKMA has agreed to an extension of time;
- c. holding of any share capital by virtue of specified underwriting or subunderwriting contracts, provided that the period of 7 working days after the acquisition of the share capital has not expired, unless the HKMA has agreed to an extension of time and any additional conditions are complied with;
- d. any commitment to acquire the share capital of any company or companies under an underwriting or subunderwriting contract that falls within an equity exposure under rule 8(2)(i);
- e. 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, insurance business, investments or other financial services;
- f. in respect of any holding, approved by the HKMA, of share capital which is deducted in determining the capital base of the AI under Part 3 of the Capital Rules;
- g. any equity exposure up to the amount incurred by the AI specifically to offset the above items;

- h. any equity exposure arising from the holding of assets, or incurring of liabilities, in relation to a defined benefit pension fund or plan; or
- i. any equity exposure that is specified in a consent given by HKMA and in relation to the consent any conditions imposed are complied with?

With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions was repealed. The BELR on equity exposures have come into effect 13 July 2018. Please refer to BELR for the details of requirements.

**Notes:**

BELR 9 [1] *Part 2 of the BELR, which includes the above rules, do not apply to AIs incorporated outside Hong Kong.*

BELR 5 [2] *The HKMA may require the rules to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

[3] *Please note that if the scope of sections 63(3) and/or 63(3A) reporting covers the periods up to 12 July 2018, sections 87 and 90 of the Banking Ordinance are still applicable for those periods up to 12 July 2018.*

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:**

79A [1] *The HKMA may require section 87A 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.*



**Part XVIA Capital Requirements**

**11. Capital requirements**

97C(5) Has the AI complied with the rules made under section 97C(1)?

97D(1)&(2) Has the AI notify the HKMA in compliance with the prescribed notification requirement?

**Notes:**

97C(1)&(2) [1] *The HKMA may, after consultation with the Financial Secretary and (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, make rules prescribing capital requirements for AIs, taking into account the risks associated with the AIs and for connected purposes.*

97C(3) [2] *The rules made under section 97C(1), may*

- (a) make different provisions for different classes of AIs, taking into account the risks associated;*
- (b) give effect to banking supervisory standards relating to capital issued by the Basel Committee, whether in whole or in part and subject to any modifications the HKMA thinks fit;*
- (c) apply, adopt or incorporate by reference, with or without modifications, any document relating to capital issued by the Basel Committee, whether in whole or in part and whether in force at the time of issue or as in force from time to time;*
- (d) if the AI has one or more than one subsidiary, specify, or empower the HKMA to specify, that any capital requirement rule applicable to the AI is to apply to the AI on an unconsolidated basis, to the AI and one or more of such subsidiaries on a consolidated basis, or both;*
- (e) provide that a matter prescribed in the rules must immediately notify the HKMA or must provide particulars to the HKMA on request;*
- (f) provide for the HKMA, on application made by an AI aggrieved by a decision of the HKMA, to review the decision;*
- (g) prescribe a capital requirement in the form of a range with upper and lower limits, and the circumstances under which the HKMA may determine a specific capital requirement within that range to apply to an AI; and*
- (h) contain incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the rules*

97D(1)&(2) [3] *"Prescribed notification requirement" means a requirement prescribed in the rules made under section 97C(1) to the effect that an authorized institution must in respect of a matter prescribed in the rules immediately notify the HKMA. If, in compliance with a prescribed notification requirement, an AI notifies the HKMA of a failure to comply with a capital requirement rule relating to a minimum level of capital to be maintained by the AI, the HKMA must immediately notify the Financial Secretary and provide the Financial Secretary with any particulars of the failure that the Financial Secretary requires.*

97E(1)&(2) [4] *If the AI contravenes section 97C(5) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.*

97F(1) [5] *The HKMA may vary any capital requirement rule applicable to a particular AI.*

97B [6] *The requirement does not apply to AIs incorporated outside Hong Kong.*

**Part XVIB Liquidity Requirements**

**12. Liquidity requirements**

97H(6) Has the AI complied with the rules (i.e. the Banking (Liquidity) Rules) made under section 97H(1) and the Code of Practice made under section 97M(1) (where applicable) on all positions that are applicable to the AI?

97I(1)&(2) Has the AI notified the HKMA of a relevant liquidity event (as defined in Rule 14 of the Banking (Liquidity) Rules) in compliance with the prescribed notification requirement?

**Notes:**

97H(1)&(2) [1] *The HKMA may, after consultation with the Financial Secretary and (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, make rules prescribing liquidity requirements for AIs, taking into account the liquidity risks associated with the AIs and for connected purposes.*

97H(3) [2] *The rules made under section 97H(1), may*

- (a) make different provisions for different classes of AIs, taking into account the liquidity risks associated;*
- (b) give effect to banking supervisory standards relating to liquidity issued by the Basel Committee, whether in whole or in part and subject to any modifications the HKMA thinks fit;*
- (c) apply, adopt or incorporate by reference, with or without modifications, any document relating to liquidity issued by the Basel Committee, whether in whole or in part and whether in force at the time of issue or as in force from time to time;*
- (d) in respect of an AI incorporated in Hong Kong, specify, or empower the HKMA to specify, that any liquidity requirement rule applicable to the AI is to apply on the basis that the business of the AI includes all or any part of its business in or outside Hong Kong;*
- (e) in respect of an AI incorporated in Hong Kong that has one or more than one associated entity within the meaning of section 97H(4), specify, or empower the HKMA to specify that any liquidity requirement rule applicable to the AI is to apply to the AI on an unconsolidated basis, to the AI and one or more of such entities on a consolidated basis, or both;*
- (f) in respect of an AI incorporated outside Hong Kong, specify, or empower the HKMA to specify, that any liquidity requirement rule applicable to the AI is to apply only to the business of the AI in Hong Kong;*
- (g) provide that a matter prescribed in the rules relating to an AI is a matter in respect of which the AI must immediately notify the HKMA and must provide particulars to the HKMA on request;*
- (h) provide for the HKMA, on application made by an AI aggrieved by a decision of the HKMA, to review the decision;*
- (i) prescribe a liquidity requirement in the form of a range with upper and lower limits, and the circumstances under which the HKMA may determine a specific liquidity requirement within that range to apply to an AI; and*
- (j) contain incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the rules*

97I(1)&(2) [3] *"Prescribed notification requirement" means a requirement prescribed in the rules made under section 97H(1) to the effect that an AI must in respect of a matter prescribed in the rules immediately notify the HKMA. If, in compliance with a prescribed notification requirement, an AI notifies the HKMA of a failure to comply with a liquidity requirement rule relating to a minimum level of liquidity to be maintained by the AI, the HKMA must immediately notify the Financial Secretary and*

*provide the Financial Secretary with any particulars of the failure that the Financial Secretary requires.*

*Pursuant to the Banking (Liquidity) Rules, those "relevant liquidity events" prescribed in rule 14(3) are subject to "prescribed notification requirement".*

- 97J(1)&(2) [4] *If the AI contravenes section 97H(6) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.*
- 97K(1) [5] *The HKMA may vary any liquidity requirement rule applicable to a particular AI.*
- 97M(1)&(2) [6] *The HKMA may, after consultation with (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, approve and issue any codes of practice (whether prepared by the HKMA or not) that the HKMA considers appropriate; or approve any codes of practice issued or proposed to be issued otherwise than by the HKMA that the HKMA considers appropriate.*

### **13. Charges over assets**

- 119A(2) 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.*

- 119A(3) [2] *The MA may, by notice published in the Gazette, specify a charge, or a class of charge, to which the above section does not apply.*

### **14. Civil proceedings**

- 119A(4) 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.*

## APPENDIX 8

### Examples of Modified Auditor's Assurance Reports

#### Example 1 – Section 63(3) report

*The following example of a qualified report is for guidance only and is not intended to be exhaustive or applicable to all situations. It is based on Examples 1 and 2 in Appendix 1.*

**The situation where the auditor has identified errors to the institution's Returns but in the auditor's professional judgement, the effect of a matter is not so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:**

...

*Auditor's Responsibilities*

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

*Basis for Qualified Opinion*

In respect of opinion below, we identified that [insert the errors] and the details are set out [in the appendix to this report][below].

*Qualified Opinion*

Based on the foregoing, in our opinion, except for the effect of the matter described in the Basis for Qualified Opinion section of our report, the Returns have been correctly complied, in all material respects, from the books and records of the Institution.

...

**Example 2 – Section 63(3A) report**

*The following examples of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on Example 3 and 4 in Appendix 1.*

**Option (i): The situation where the auditor has identified exceptions to the institution's systems of internal control for conclusion 1 but in the auditor's professional judgement, the effect of a matter is not so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:**

*Basis for Qualified Conclusion*

We identified exception[s] to the Institution's internal controls over [compilation of returns and information] / [compliance with its duties under [insert relevant sections of the Ordinance] / [maintenance of adequate provision for [insert relevant items referred to in section 63(3A)(a)(iii)] as set out in [the appendix to this report][below].

*Qualified Conclusion*

Based on the foregoing:

1. in our opinion, except for the effect of the matter described in the Basis for Qualified Conclusion section of our report, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section [63(3A)(a)] [63(3A)(a)(i) and (ii)]\* of the Ordinance, were established and maintained, in all material respects, in accordance with the requirements set out in SPM IC-3; and
2. <sup>#</sup>[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, XVIA or XVIB 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.] or

[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 XVIB of the Ordinance.]\*

**Option (ii): The situation where the auditor has identified exceptions to the institution's systems of internal control for conclusion 1 and in the auditor's professional judgement, the effect of a matter is so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:**

*Basis for Adverse Conclusion*

We identified exception[s] to the Institution's internal controls over [compilation of returns and information] / [compliance with its duties under [insert relevant sections of the Ordinance] / [maintenance of adequate provision for [insert relevant items referred to in section 63(3A)(a)(iii)] as set out in [the appendix to this report][below].

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<sup>#</sup> The auditor should consider the implication on the conclusion 2 in respect of the exceptions identified for conclusion 1.

*Adverse Conclusion*

Based on the foregoing:

1. in our opinion, because of the significance of the matter described in the Basis for Adverse Conclusion section of our report, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section [63(3A)(a)] [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; 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, XVIA or XVIB 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.] or

[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 XVIB of the Ordinance.]\*

\*Delete where not applicable

**APPENDIX 9**

**Part A**

Information maintained by management as an audit trail for adjustments made after a return is first submitted:

- Name of the Relevant Return
- Reference to the applicable line item(s) in the return
- Amount reported in the originally submitted return
- Amount relating to error(s) from compilation identified by management
- Reason for the error occurred and how management detected it
- Amount relating to financial statements / accounting books closing adjustment
- Description of the financial statements / accounting books closing adjustment
- Adjusted amount as reported in the Relevant Return

**Part B**

Summary of material errors identified by the auditor in the Relevant Return(s) submitted by AI on [Date] that is to be included in the auditor's report for section 63(3) reporting:

<b>[Name of the Relevant Return]</b>					
Reference in the Relevant Return	Description of the reported line item in the Relevant Return	Amount as reported in the Relevant Return	Material errors identified (HK\$'000)	Adjusted amount (HK\$'000)	Description of errors
		(A)	(B)	(C) = (A)+(B)	

## APPENDIX 10

### Guidance on “Two-tier” materiality approach

In evaluating whether or not an identified error is material for reporting under section 63(3) of the Ordinance, the auditor would need to consider both the quantitative and qualitative impact of the error on the Relevant Return. Such an impact could vary depending on the return being reviewed or the circumstances of the institution. For example, a small error could lead to a breach of a debt covenant limit on a prudential ratio for an AI. Hence the qualitative aspects would also need to be assessed by the auditor on a case-by-case basis. The “Two-tier” materiality approach described here focuses on both the quantitative and qualitative aspects of materiality considerations.

The “Two-tier” materiality approach considers materiality in two stages. A first-tier general quantitative benchmark (a difference of 5% or more to the particular line item in the return) and second-tier benchmarks determined quantitatively or qualitatively based on the main purpose of the return. For example, the total capital base or the total risk-weighted assets amounts are the key determinants of the capital adequacy ratio which is the focus of the Return of Capital Adequacy Ratio. Similarly, the broader classification of loan usage and loan quality under the five-grade loan classification system would be considered important for the Loans and Advances and Provisions Return.

In identifying the second-tier benchmarks, the auditor may consider factors such as the supervisory objectives and the focus of the return, the HKMA’s reasons for selecting a particular return for examination, as well as findings from the HKMA or the auditor in respect of past submissions.

Depending on the circumstances of the institution, the HKMA may require a return other than the more common set of returns to be reported on under section 63(3) of the Ordinance. In such circumstances, it is recommended that the auditor seeks to discuss and understand from the HKMA and the AI the reasons for selecting the return and agree a materiality benchmark to assist in determining what should constitute a material error to be reported.

The table below sets out certain considerations to assist in determining materiality benchmarks for the more commonly examined returns under section 63(3) of the Ordinance. They are intended as a reference for the auditor to consider in exercising professional judgement which should take into account other factors described within this PN. Alternative benchmarks that the auditor develops for a particular engagement could be warranted and applied. In addition, the auditor should consider whether the errors identified are individually material or material in aggregate and the qualitative aspects of the errors. Any quantitative error identified should be considered with respect to the AI’s size, risk profile, business activities and strategy in determining whether the identified error would be of major concern to the HKMA and hence warrant reporting under section 63(3) of the Ordinance. Material errors, regardless of their causal factors, should be reported to the HKMA. In this connection, the auditor should gather sufficient evidence to form such judgement.



**Possible factors to be considered in determining the materiality benchmarks (non-prescriptive and non-exhaustive)**

Returns	Possible considerations
Return of Capital Adequacy Ratio ("CAR")	<ul style="list-style-type: none"> <li>• The capital adequacy ratio ("CAR") is an important prudential measure that the HKMA uses to assess the capital adequacy position of a locally incorporated AI. AIs must meet the regulatory minimum CAR thresholds as set out in the Ordinance and by the HKMA. While the absolute amount of error identified may not be material quantitatively, if the error has resulted in a breach of regulatory minimum limits or requirements for different capital adequacy measures (e.g. Common Equity Tier 1 Capital Ratio, Tier 1 Capital Ratio, various Capital Buffer Ratios), the error will be considered as material qualitatively. Also, the materiality threshold should be adjusted downward when the relevant capital adequacy measures of the AI are close to the regulatory limits or requirements or the AI's internal triggers.</li> <li>• As the CAR is calculated by dividing the capital base by risk-weighted assets, any material errors in either or both of these two components would be considered significant even if the overall impact of various errors may work to offset each other leading to only a small impact on the CAR. For example, there may be errors affecting both the numerator and denominator which offset each other leading to a largely unchanged CAR. Errors that materially affect the measurement and classification of different tiers of capital (i.e. Tier 1, Common Equity Tier 1, Additional Tier 1 and Tier 2) or risk-weighted amount of major items under different risk exposures (i.e. credit risk, market risk and operational risk) should therefore be reported.</li> <li>• For additional guidance, Appendix 10.1 of this PN has set out a list of reporting items that are typically considered important in the context of examining the CAR return for reference.</li> </ul>
Return of Liquidity Position	<ul style="list-style-type: none"> <li>• The liquidity ratio (LCR or LMR) is an important prudential measure that the HKMA uses to assess whether an AI maintains a sufficient level of liquidity to allow it to operate smoothly within the banking system. While the absolute amount of error identified may not be material quantitatively, if the error has resulted in a breach of regulatory minimum limit, the error will be considered as material qualitatively. In addition, the materiality threshold should be adjusted downward when the actual prudential ratio of the AI is close to the regulatory limit or requirements or the AI's internal triggers.</li> <li>• The LCR is comprised of the numerator – "HQLAs" and the denominator – "expected cash inflows and outflows". The LMR is comprised of the numerator – "liquefiable assets" and the denominator – "qualifying liabilities". A material error in either or both the numerator or denominator will likely to be considered significant even if the overall impact of various errors may work to offset each other leading to only a small impact on the LCR or LMR. For example, there may be errors affecting both the numerator and denominator which offset each other leading to a largely unchanged LCR or LMR. Errors that materially affect the measurement and classification of different levels of HQLA (i.e. Level 1, 2A and 2B) and different liquidity inflow or outflow items (e.g. different types of secured lending transactions, stable and less stable deposits/funding) for LCR should therefore be reported. For additional guidance, Appendix 10.2 of this PN has set out a list of reporting items that are typically considered important in the context of examining the LCR return for reference.</li> <li>• Equally, errors that materially affect the measurement and classification of different categories of liquefiable assets and qualifying liabilities (e.g. those maturing within one month and over one month) before and after deductions for LMR should also be reported.</li> </ul>

**Possible factors to be considered in determining the materiality benchmarks (non-prescriptive and non-exhaustive) (Continued)**

Returns	Possible considerations
Return of Large Exposures	<ul style="list-style-type: none"> <li>• This return collects information on the AI's large exposures to banks, non-bank entities and connected parties which, in turn, is a reflection of the concentration risk of the AI. Error that significantly shifts the large exposures concentration distribution will likely be considered as material. Errors which are considered as immaterial with reference to the total top ten exposures but are in fact material for exposures to any individual counterparty will also warrant reporting by the auditor.</li> <li>• The HKMA requires the top ten counterparties to be reported in order to allow it to understand an AI's concentration risk and for its analytical purposes. It is therefore important to ensure that the top ten counterparties reported are the correct set of counterparties with their amount of exposures accurately captured and ranked.</li> <li>• If an error has resulted in a breach of the AI's internal or regulatory large exposures limit, such an error will be considered material even if the absolute amount of the error may not be material quantitatively.</li> </ul>
Return of Loans and Advances and Provisions	<ul style="list-style-type: none"> <li>• This return analyses, by economic sector, an AI's loans and advances for use in Hong Kong. It also analyses the performance of an AI's selected assets (mainly loans and advances) and off-balance sheet exposures according to the classification methods defined in the completion instructions. The information serves a statistical purpose as well as a prudential purpose allowing the HKMA to assess any particular concentration from an industry segment perspective. An error that significantly shifts any of the major industry segment distribution will likely be considered as material.</li> <li>• Similarly, errors that materially affect the different categories of loan classification and provisions, overdue and rescheduled assets, details of ten largest exposures in each of the criticized asset grades should also warrant reporting by the auditor.</li> </ul>
Return of Mainland Activities	<ul style="list-style-type: none"> <li>• This return collects information on the Mainland-related business activities of an AI and their Mainland bank subsidiaries by various classification measures. Given the importance of the Mainland China economy to the Hong Kong banking sector, this allows the HKMA to monitor changes in an AI's exposure to the Mainland-related business activities. Error that significantly shifts the concentration distribution of the exposures under various sections of the return will likely be considered as material.</li> <li>• Similarly, errors that materially affect the major categories of balance sheet and profit and loss items and non-bank Mainland China exposures to different:             <ol style="list-style-type: none"> <li>a. types of counterparties;</li> <li>b. geographical locations in Mainland China;</li> <li>c. major economic sector categories;</li> <li>d. loan classification categories;</li> <li>e. risk mitigation types;</li> </ol>             and details of the top ten non-bank Mainland China exposures should be reported.           </li> </ul>

**Return of Capital Adequacy Ratio (“CAR”)**

The following reporting items are typically considered important in the context of examining the CAR return. Material errors in these reporting items would normally warrant reporting by the auditor. These reporting items include:

**1. Capital Base**

- i. Tier 1 Capital
  - Common Equity Tier 1 (“CET1”) Capital before and after deductions
  - Additional Tier 1 Capital before and after deductions
- ii. Tier 2 Capital before and after deductions
- iii. Total Capital

**2. Risk Weighted Amount (“RWA”)**

- i. Total risk weighted amount for credit risk (Basic (“BSC”) Approach) for On-balance sheet and Off balance Sheet Exposures
- ii. Total RWA for credit risk (Standardized (Credit risk) (“STC”) Approach) for On-balance sheet and Off balance Sheet Exposures
- iii. Total RWA for credit risk (Internal ratings-based (“IRB”) Approach) for On-balance sheet and Off balance Sheet Exposures by IRB Class / Subclass
- iv. Total RWA for credit risk for exposures to Central Counterparties (“CCP”)
- v. Total RWA for credit risk for advanced / standardized Credit Valuation Adjustment (“CVA”) method (only for AIs not using IRB approach)
- vi. Total RWA for credit risk under STC (Securitization) Approach / IRB (Securitization) Approach
- vii. Total RWA for market risk
- viii. Total RWA for operational risk
- ix. Total additional RWA due to application of capital floor (only for AIs using IRB Approach)
- x. Total deductions to RWA

**3. Common Equity Tier 1 Capital Ratio****4. Net CET 1 Ratio****5. Tier 1 Capital Ratio****6. Total Capital Ratio****7. IRB coverage %****8. Capital Buffer Requirements - Buffer level %**

which is the sum of:

- i. Capital conservation buffer ratio %
- ii. Countercyclical capital buffer ratio %
- iii. Higher loss absorbency ratio %

**Return of Liquidity Position - Liquidity Coverage Ratio (“LCR”)**

The following reporting items are typically considered important in the context of examining the LCR return. Material errors in these reporting items would normally warrant reporting by the auditor. These reporting items include:

**1. Weighted amount of High Quality Liquid Assets (“HQLA”)**

- i. Total Level 1 assets (before deductions)
- ii. Total Level 2A assets (before deductions)
- iii. Total Level 2B assets (before deductions)
- iv. Deductions to weighted amount of HQLA
- v. Total HQLA (after deductions)

**2. Weighted amount of Expected Cash Outflows**

- i. Retail deposits (stable, less stable and term)
- ii. Small business funding (stable, less stable and term)
- iii. Operational deposits
- iv. Unsecured wholesale funding (other than small business funding)
- v. Debt securities and prescribed instruments issued by the reporting institution and redeemable within the LCR period
- vi. Secured funding transactions (other than securities swap transactions)
- vii. Securities swap transactions
- viii. Contractual net cash outflows arising from derivatives contracts and other transactions, and additional liquidity needs arising from related collateral requirements
- ix. Cash outflows arising from obligations under structured financing transactions and repayment of funding obtained from such transactions
- x. Potential drawdown of undrawn committed facilities (including committed credit facilities and committed liquidity facilities)
- xi. Contractual lending obligations (not otherwise covered above) and other contractual cash outflows
- xii. Other contingent funding obligations (whether contractual or non-contractual)
- xiii. Total expected cash outflows

**3. Weighted amount of Expected Cash Inflows**

- i. Secured lending transactions (including securities swap transactions)
- ii. Secured and unsecured loans (other than secured lending transactions)
- iii. Operational deposits placed at other financial institutions
- iv. Other contractual cash inflows
- v. Total expected cash inflows (after application of 75% inflow ceiling)

**4. Liquidity Coverage Ratio (LCR) %**

## APPENDIX 11

### Suggested procedures pertaining to specific returns

The auditor 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. The auditor 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 the auditor 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 "Common Equity Tier 1 capital" ("CET1 Capital") and "Tier 2 capital";
- Perform checks as to whether the amounts and nature of capital items recognized as "regulatory 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 "regulatory capital";
- Perform checks as to whether the specified items are deducted from the CET1 capital, Additional Tier ("AT") 1 capital and Tier 2 capital in accordance with the completion instructions;
- Check that the AI has properly calculated the Net CET1 capital ratio and the buffer level in accordance with the completion instructions;
- Check that the AI has properly calculated the risk-weighted amount for credit risk, market risk and operational risk in relation to its on- and off-balance sheet exposures as the case requires, taking into account the relevant criteria, such as the type of instrument or exposure, the nature of counterparties, the maturity of the exposure and the approach it adopts to calculate the capital requirements for those exposures.
- With respect to certain items that need to be reported by the AI based on approach as agreed with the HKMA (such as the IRB Approach for calculating the risk weighted amount for credit risk and the IMM approach for calculating the risk weighted amount for market risk), the auditor is expected to carry out procedures to ensure that relevant established methodologies, including those key assumptions identified by management, have been applied in determining the amounts of such items for reporting in the return. As part of section 63(3A) work, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions. Certain elements of such control framework could be tested as part of the section 63(3) work procedures if relevant controls are relied upon (e.g., testing the logical access controls around changing assumptions or inputs to a model). It should be noted, however, the objective and scope of such work procedures is not intended to address the appropriateness or suitability of these key assumptions, systems and methodologies. Accordingly, the auditor's opinion in section 63(3) report would not provide assurance over the appropriateness or suitability of these key assumptions, systems and methodologies applied by management.

*b. Large Exposures*

- Obtain an understanding of how the AI captures and reports its large exposures to banks, non-bank entities and connected parties, and of the controls and processes operated by the AI to identify the linked counterparties;
- Obtain a list of connected parties (as defined in the completion instructions) and perform procedures to ascertain completeness;
- Perform checks that counterparties which are linked 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 checks on individual exposure amounts to determine whether on-balance sheet exposures, off-balance sheet exposures, default risk exposures and any other risk exposures which may cause material impact on the AI's concentration risk, are captured and whether indirect exposures (e.g. guarantees granted by the counterparty) are also appropriately identified and reported;
- Perform checks as to whether exposure amounts (aggregating all facilities) for individual counterparties or groups of linked counterparties have been captured on a daily basis and that the maximum exposure is identified from the daily reported exposures;
- Review the nature of counterparties or groups of linked counterparties and assess the appropriateness of classification within the relevant parts of the return.

*c. Liquidity*

- The LCR introduced in liquidity regulations in January 2015 applies to AIs designated by the HKMA (in accordance with Rule 3 of the Banking (Liquidity) Rules) as "category 1 institutions". All other AIs not designated by the HKMA as category 1 institutions are required to comply with the LMR requirements (category 2 institutions);
- For category 1 institutions under the LCR framework:
  - Obtain an understanding of how the AI recognizes relevant assets as HQLAs, and reports expected cash inflows and outflows (with the latter including both contractual and non-contractual cash outflows) in accordance with the criteria set out in the Banking (Liquidity) Rules, the Code of Practice<sup>21</sup> and the completion instructions;
  - Perform sample checks as to whether various types of HQLAs, expected cash inflows and outflows have been appropriately classified according to their nature, and that they qualify for inclusion as HQLAs, expected cash inflows and outflows according to criteria set out in the Banking (Liquidity) Rules, the Code of Practice and the completion instructions;

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<sup>21</sup> This refers to the "Code of Practice for the Purposes of Providing Guidance in Respect of the Provisions of Division 5 (Calculation of Total Net Cash Outflows) of Part 7 of the Banking (Liquidity) Rules", which is issued by the HKMA in December 2014 under section 97M of the Banking Ordinance.

- With respect to certain expected cash flow items (such as "operational deposits", "potential drawdown of undrawn committed facilities" and "non-contractual contingent funding obligations") that need to be reported by category 1 institutions based on certain estimation methodologies as required by the HKMA, auditors are expected to carry out procedures to ensure that relevant established methodologies, including those key assumptions identified by management, have been applied in determining the amounts of such expected cash flow items for reporting in the return. As part of section 63(3A) work, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions. Some of the elements of such control framework could be tested as part of the section 63(3) work procedures if relevant controls are relied upon (e.g., testing the logical access controls around changing assumptions or inputs to a model). It should be noted, however, the objective and scope of such work procedures is not intended to address the appropriateness or suitability of these key assumptions, systems and methodologies. Accordingly, the auditor's opinion in section 63(3) report would not provide assurance over the appropriateness or suitability of these key assumptions, systems and methodologies applied by management.
- For category 2 institutions under the LMR framework:
  - Obtain an understanding of how the AI recognizes relevant assets and liabilities as "liquefiable assets" and "qualifying liabilities (after deductions)" according to the criteria set out in the Banking (Liquidity) Rules and the completion instructions;
  - Perform sample checks to ascertain whether various types of liquefiable assets and qualifying liabilities (after deductions) 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 (after deductions) according to the criteria set out in the Banking (Liquidity) Rules and completion instructions;
  - With respect to certain types of "other one-month liabilities" (such as "irrevocable commitments") that need to be reported by category 2 institutions based on certain estimation methodologies as required by the HKMA, the auditor is expected to carry out procedures to ensure that relevant established methodologies, including any key assumptions identified by management, have been applied in determining the amounts of such liability items for reporting in the return. It should be noted, however, that the auditor's opinion in section 63(3) report would not address the appropriateness or suitability of such assumptions and methodologies. (Please also refer to the guidance provided in the 3rd bullet for category 1 institutions above.)
  - Confirm with the AI whether the HKMA has given approval to the AI to calculate the monthly "average LMR" (to be reported under Section (II) in Part 3 of the return) on the basis of specified days during the month and perform checks as to whether the AI calculates the ratio on the basis agreed with the HKMA.
- For the purpose of calculating the lowest LCR or LMR during the month, perform checks to ascertain whether the AI determines the ratio as the lowest LCR or LMR recorded at the close of business on all working days 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\*, 87A\*, 88\* and 119A\*, as well as Part 2 of the BELR, during the reporting period. With effect from 13 July 2018, sections 87 and 90 were repealed and BELR has come into effect on that date<sup>22</sup>;
- Obtain correspondence setting out the capital and liquidity requirements prescribed by the HKMA for the AI for the purpose of compliance with sections 97C(1) as varied by section 97F(1)\* and 97H(1) ) as varied by section 97K(1);
- For item 9 under Part II of the MA(BS)1F(a) return\* (or item 2(c) of the MA(BS)1F(b) return for AIs incorporated outside Hong Kong) on minimum liquidity requirements during the reporting period, perform checks on compliance with the minimum liquidity requirements of LCR and NSFR under rule 4, rule 8A and 8B of the Banking (Liquidity) Rules respectively for category 1 institutions. Where applicable, perform checks on compliance with the minimum liquidity requirements of LMR under rule 7 of the Banking (Liquidity) Rules for category 2 institutions and the minimum CFR under rule 8D of the Banking (Liquidity) Rules for category 2A institutions.
- 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 are exempted under sections 81, 83 and 88\* or Rule 13 of the BELR. With effect from 13 July 2018, section 87 was repealed and BELR has come into effect on that date<sup>22</sup>;
- Check the calculations for the maximum ratio of pledged assets and ensure the amounts used are 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

e. *Quarterly Analysis of Loans And Advances And Provisions*

- Obtain an understanding of how the AI captures and reports its loans and advances and provisions in the appropriate assets category in Part 1 - Loans and advances and provisions and various on-balance sheet assets and off-balance sheet contingencies items according to the loan classification system in Part 2 - Loan classification and provisions according to the completion instructions;
- For AIs whose internal classification system is different from the HKMA five-grade loan classification system, understand and evaluate the internal classification system of the AI and the methodology for mapping the internal classifications to the HKMA's loan classifications for the purpose of reporting to the HKMA;
- Perform sample checks on individual loans and advances items to determine whether these items are properly classified based on their loan usage as loans and advances for use in Hong Kong, trade financing loans and other loans and advances. For loans and advances for use in Hong Kong, perform further sample checks on the classification of the individual loans and advances items to each economic sector;

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<sup>22</sup> Please note that if the scope of sections 63(3) and/or 63(3A) reporting covers the periods up to 12 July 2018, sections 87 and 90 of the Banking Ordinance are still applicable for those periods up to 12 July 2018.



- Check that provisions made have been appropriately classified into specific provisions and general provisions and correctly reported;
- Perform sample checks as to whether loans and advances, balances due from banks, acceptances and bills of exchange held, investment debt securities and commitments and contingent liabilities of similar nature into the categories have been properly classified according to the loan classification system and whether the loan classifications are properly determined in accordance with the HKMA's loan classification system;
- Check that the AI has properly captured and reported the required amounts for any of the notes under Note (1) to Note (7) that are within the scope of section 63(3) reporting. For Note (3) – Overdue and rescheduled assets, check that the AI has properly identified and classified the assets according to their nature to report these assets as overdue and rescheduled in accordance with the completion instructions.

*f. Mainland Activities*

- Obtain an understanding of how the AI captures and reports the balance sheet and profit and loss account for position of its subsidiary bank(s) in Mainland China and the non-bank Mainland China exposures with their related breakdowns (i.e. breakdown by type and counterparty, geographical location in Mainland China, economic sector, loan classification and risk mitigation type) according to the criteria set out in the completion instructions;
- With respect to the balance sheet and profit and loss account for position of its subsidiary bank(s), obtain the trial balance(s) of its subsidiary bank(s) and check the appropriateness on the mapping of the accounts in the trial balances to the reportable items in the return according to the criteria set out in the completion instructions;
- With respect to non-bank Mainland China exposures counterparties' type, geographical location, economic sector, loan classification and risk mitigation type, the auditor is expected to perform appropriate procedures to ensure that relevant established classification methodologies, including any key assumptions adopted by management, have been applied in determining the amounts of such exposures for reporting in the return. As part of the examination under section 63(3A) of the Ordinance, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions.
- Perform sample checks to ascertain whether various breakdowns of non-bank Mainland China exposures have been appropriately classified according to their type and counterparty, geographical location in Mainland China, economic sector, loan classification and risk mitigation type; and
- With respect to top ten largest non-bank Mainland China exposures and ten largest exposures to PRC nationals residing in Mainland China or entities beneficially-owned by Mainland interest:
  - Obtain an understanding of how the AI captures and reports large exposures; and
  - Perform sample checks on individual exposure amounts to determine whether on-balance sheet exposures and off-balance sheet exposures are appropriately identified and reported.