



## Supervisory Policy Manual

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Internal Audit Function

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

### Purpose

To set out the HKMA's expectations on the key role, responsibilities and qualities of an AI's internal audit function, and describe the approach that the HKMA will adopt in assessing the effectiveness of the function

### Classification

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

### Previous guidelines superseded

This is a new guideline

### Application

To all AIs

### Structure

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### 1. Introduction

#### 1.1 Background

1.1.1 Para. 10 of the Seventh Schedule to the Banking Ordinance requires AIs to maintain, on and after authorization, adequate accounting systems and adequate systems of control. It is therefore important for the board of directors (“Board”) and senior management of an AI to monitor and assess whether the AI’s internal control systems are adequate, particularly in relation to ensuring effective governance and risk management, reliable and timely reporting of financial and management information, and compliance with relevant laws and regulations, supervisory guidelines, market codes and standards, as well as internal policies and procedures.

1.1.2 An internal audit function (“IAF”) is essential to the maintenance of adequate internal control systems in that it provides the Board and senior management of an AI with an independent, objective evaluation of the condition of the AI’s systems and controls on an ongoing basis, and helps in improving their effectiveness by identifying weaknesses to be rectified and making recommendations for enhancement. This independent evaluation process is crucial to an AI’s continuing development in the light of the rapidly changing business environment that may bring about new risks and control challenges to the AI.

1.1.3 An effective IAF also facilitates the supervisory work of the HKMA by providing a valuable source of information that it may take into account for assessing the quality of an AI’s internal control systems.

#### 1.2 Application

1.2.1 Every AI is expected to maintain an IAF that is appropriate for the size, nature and scope of its operations. With the increasing trend of AIs diversifying their activities into different products and markets and the growing complexity of the business environments in which they operate, AIs should recognise the need to continuously upgrade their internal control systems, and to have an IAF that is equipped with the necessary expertise, resources and authority to safeguard the integrity of these systems.



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- 1.2.2 Locally incorporated AIs should apply the standards set out in this module to their business activities on a group-wide basis. Where an AI has a significant branch or subsidiary abroad, the AI should consider establishing an internal audit office there to ensure the efficiency and continuity of the internal auditing work on those operations. Such overseas offices should be part of the AI's IAF and be able to comply with the requirements of this module. The AI should also ensure that the IAF has unlimited access to the activities of all of its branches and subsidiaries, whether domestic or overseas, and that the IAF carries out on-site audits of those activities at sufficiently regular and timely intervals to ensure that internal control systems are functioning adequately and properly.
- 1.2.3 For AIs which are branches or subsidiaries of foreign banks (including subsidiaries of regulated financial holding companies), the HKMA will take into account the work of their group IAF on their local operations in assessing whether they satisfy the standards set out in this module. Where their local operations are sizeable in terms of the risks posed to the institutions themselves and the market as a whole, they are expected to have their own internal auditors in Hong Kong as part of their group IAF. Those with small operations in Hong Kong may, subject to the requirements of this module, rely on their group IAF and/or competent external parties to whom internal audit activities have been outsourced (see section 6 for more details) to cover such operations.
- 1.2.4 AIs that do not conform fully with the standards set out in this module should satisfy the HKMA that alternative measures are in place which are equally robust in achieving the purposes of these standards.
- 1.2.5 Where necessary, AIs are expected to refer to the latest professional standards and best practices published from time to time by professional bodies such as the Institute of Internal Auditors for further guidance on a more technical level.

## 2. Hierarchy of responsibilities

### 2.1 General



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2.1.1 The effectiveness of an IAF depends to a large extent on the commitment of the Board and senior management of an AI to maintaining strong internal control systems that are responsive to the changing landscape of risks faced by the AI, as well as an adequately resourced and competent IAF to help ensure that this is the case.

2.1.2 This section sets out the HKMA's expectations on the key responsibilities of the Board and senior management for ensuring the effectiveness of an AI's internal control systems, and those of the IAF in assisting the Board and senior management in fulfilling their responsibilities.

### 2.2 Board of directors

2.2.1 The Board has the ultimate responsibility for ensuring that the internal control systems and procedures in place are effective given the size, nature and complexity of the AI's business activities. In this regard, the Board should, among other things –

- have a broad understanding of the risks inherent in the AI's business activities (including those arising from any new developments, initiatives, products and operational changes), with focus on those that may be material to the business and affairs of the AI;
- ensure the competence of senior management in establishing, implementing and maintaining –
  - an adequate and effective system of internal controls;
  - a process for identifying, assessing and controlling the various risks of the AI's business activities;
  - appropriate methods for monitoring compliance with laws, regulations, supervisory guidelines and internal policies; and
- review the effectiveness of the AI's internal control systems and procedures at least once a year (or on a more frequent basis as necessary). Such review may be conducted by the Audit Committee as appropriate.

2.2.2 In respect of internal audit, the Board is broadly responsible for ensuring that the IAF is effective in performing an independent assessment of the adequacy



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of internal control systems in covering all relevant risks of the AI. Detailed responsibilities that the Board may delegate to the Audit Committee to ensure the effectiveness of the IAF are included in subsection 2.5.

### 2.3 Senior management

2.3.1 Senior management is responsible for the establishment, implementation and maintenance of effective systems of internal control within the AI. Accordingly, senior management should, among other things –

- maintain an organisational structure that clearly assigns responsibility, authority and reporting relationships and ensure that delegated responsibilities are effectively carried out;
- develop processes and procedures at a sufficiently detailed level to identify, measure, monitor and control risks inherent in the AI's business activities (including those arising from any new developments, initiatives, products and operational changes);
- set appropriate internal control policies and monitor the effectiveness of the AI's internal control systems; and
- report to the Board at least once a year (or on a more frequent basis as necessary) on the scope and performance of the AI's internal control systems.

2.3.2 In respect of internal audit, senior management is responsible for ensuring that the recommendations of the IAF are properly implemented at all relevant levels of management. Senior management should also keep the IAF fully informed of any substantial new developments, initiatives, products and operational changes affecting the AI so that any associated risks can be identified at an early stage. In deciding the scope of information to be provided to the IAF, senior management is expected to take into account the information needs of the Head of IAF to enable him to adequately and properly discharge his responsibilities.

### 2.4 Internal audit function

2.4.1 An effective IAF assists the Board and senior management in the discharge of their responsibilities as described above. The IAF should regularly report to, and



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advise, the Board (or the Audit Committee) and senior management on the results of its assessment of the AI's internal control systems (see subsection 4.5 for relevant reporting standards).

2.4.2 The responsibilities of the IAF should include an independent assessment of the following:

- the compliance with internal policies and risk management controls as well as relevant laws, regulations, and supervisory guidelines;
- the reliability (including integrity, accuracy and comprehensiveness) and timeliness of financial and management information (including information for regulatory reporting);
- the continuity and reliability of management and financial information systems, including electronic information systems (for internal and regulatory reporting);
- the accuracy of accounting records and financial reports;
- the efficiency of operations through testing of both transactions and the functioning of specific internal control procedures; and
- the effectiveness of the systems and processes for risk management and control throughout the organisation, including safeguarding of assets and fraud detection and prevention.

2.4.3 In addition, the IAF may be involved in the carrying out of special investigations as directed by the Board (or the Audit Committee) or senior management from time to time. Such investigations may occasionally arise from supervisory requests.

2.4.4 The Head of IAF should be responsible for ensuring the effectiveness and efficiency of the IAF in discharging the above responsibilities. Specifically, the Head of IAF should –

- ensure that the IAF complies with sound internal auditing principles;



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- establish an audit charter, an audit plan, and written policies and procedures for compliance by staff in the IAF;
- ensure that staff in the IAF are professionally competent and well-trained, and that necessary resources are available; and
- establish and ensure an effective mechanism for reporting audit findings and recommendations, and the progress on implementation of the recommendations, to all appropriate levels of management.

2.4.5 Apart from providing assurance to the Board and senior management about the quality of the AI's internal control systems, the IAF, on account of its understanding of the AI's operations and auditing expertise in risk management and controls, may sometimes be called upon by senior management for advice on issues relating to the establishment of internal control systems. This is acceptable so long as it does not compromise the objectivity of the IAF in discharging its main responsibilities (see also para. 3.3.2).

### 2.5 Audit Committee

2.5.1 For practical reasons, and where the nature and scope of their operations warrant, AIs are generally expected to have an Audit Committee under the Board to assist the latter in ensuring the adequacy of internal control systems and reinforcing the work of internal and external auditors (see CG-1 "Corporate Governance of Locally Incorporated Authorized Institutions" for the relevant requirements, including the composition and functions of the Audit Committee). In this regard, the Audit Committee is expected to be delegated by the Board with the responsibilities to –

- draw up, review and update periodically a written charter for the Board's approval indicating the Audit Committee's composition, authority and duties, as well as the manner of reporting to the entire Board;
- appoint a suitably qualified Head of IAF;



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- approve the audit charter drawn up and updated periodically by the IAF (see subsection 3.2 for further details);
- approve, periodically, the audit plan as well as the manpower and financial resources required after identifying the risk areas of the AI's operations to be covered;
- review significant recommendations made by the IAF and management plans for their implementation;
- recommend to the Board the appointment of the AI's external auditors, consider their audit work plan, and review their audit conclusions and recommendations;
- report to the Board regularly on the work performed by the Committee and its significant findings; and
- provide opportunities for external and internal auditors to meet and discuss their respective findings.

2.5.2 The Board however remains ultimately responsible for the work performed by the Audit Committee, and should therefore establish adequate controls to ensure the effectiveness of the Committee in fulfilling the above responsibilities.

### 3. Key qualities expected of internal audit function

#### 3.1 Independence

- 3.1.1 The IAF must be independent from the day-to-day operations of the business and functional units and the internal control processes subject to its review.
- 3.1.2 The IAF should report directly to the highest governing levels of an AI, typically the Board (or the Audit Committee), and be given the opportunity to discuss its findings with members of the Board (or the Audit Committee) without senior management's involvement.
- 3.1.3 In the case of foreign banks which operate as branches or subsidiaries in Hong Kong, where it is not practicable for the local IAF to report directly to the Board (or the Audit Committee) of the foreign bank, the local IAF should report to the group IAF, rather than the local management.



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3.1.4 The IAF should be subject to independent review, which can be carried out by independent parties like external auditors or other qualified independent reviewers, or it can be done by the Audit Committee. Such review should aim to evaluate the effectiveness of the IAF and, where necessary, provide recommendations to improve its effectiveness. It should be conducted on an ongoing periodic basis and cover all major aspects of the IAF's work.

### 3.2 Authority and standing

3.2.1 The effectiveness of the IAF can be enhanced where its importance is recognised by the Board and senior management and communicated throughout the organisation.

3.2.2 Each AI should therefore have an audit charter to enhance the authority and standing of the IAF within the AI. The charter should be drawn up and periodically reviewed and updated by the IAF. The charter and any subsequent amendments to it should be approved by the Board (or the Audit Committee) and communicated throughout the organisation. All these processes should be properly documented.

3.2.3 An audit charter should establish –

- the objectives and scope of the IAF;
- the IAF's position within the organisation, its powers, responsibilities and relations with other control functions;
- the accountability of the Head of IAF;
- the terms and conditions according to which the IAF can be called upon to provide consulting or advisory services or to carry out other special tasks.

3.2.4 The audit charter should give the IAF the right on its own initiative to communicate directly with members of the Board (or the Audit Committee), and any member of staff, to examine any activity of the AI, as well as to access any records, files or data of the AI, including management information and the minutes of the AI's consultative and decision-making bodies, whenever relevant to the IAF's assignments.

### 3.3 Objectivity and impartiality



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3.3.1 The IAF must seek to preserve objectivity and impartiality by avoiding any conflict of interest in performing its duties. For instance,

- the IAF and its staff members must not be involved in the business and functional operations of the AI or in selecting or implementing its internal control measures;
- staff assignments within the IAF should be rotated periodically whenever practicable;
- staff members of the IAF who are recruited internally should not audit activities or functions they performed within the last 12 months;
- the Head of IAF should bear in mind the existence of any possible conflict of interest where, for example, the head or key personnel of the unit or department to be audited is a close friend or relative of the audit staff concerned;
- the Head of IAF should be responsible for ensuring that any cases of impairment, or potential impairment, of an internal auditor's objectivity are properly reported and addressed, with reporting lines clearly established and communicated to staff;
- all the work done by internal auditors should be properly documented for future verification as necessary; and
- such matters as the compensation scheme for internal auditors or budgeted resources of the IAF should be determined by the Board or the Audit Committee rather than by managers who are affected by the work of internal auditors.

3.3.2 The need for objectivity and impartiality however does not preclude the IAF from providing consulting or advisory services to senior management. For instance, senior management may request the IAF to give an opinion on the necessary internal control systems and procedures for important reorganisations, the start of important activities or activities considered to carry material risks, and the setting up or reorganisation of risk management infrastructure (including management information systems and information technology systems). This



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would be acceptable provided that such consultative and advisory services constitute only an ancillary task of the IAF and where the IAF, for example, only makes recommendations, but takes no part in the actual decision-making or the eventual development and introduction of the internal control systems or procedures, which should remain the responsibility of senior management.

### 3.4 Resources and professional competence

- 3.4.1 The IAF should be provided with adequate resources to perform its tasks. The amount of resources, in terms of human, financial and technical support, should be commensurate with the size, complexity and risk of the AI's operations. For example, the availability of skills, the knowledge and the experience of internal audit personnel should be adequate to address the nature of risks inherent in the AI's operations, and the availability of manpower should be sufficient to complete an audit cycle on major business operations within a reasonable timeframe.
- 3.4.2 Staffing and continuing professional development should be analysed and budgeted at least annually having regard to the audit plan, with particular attention given to any new knowledge and skills to be acquired, for instance, through training or recruitment.
- 3.4.3 In order to be able to discharge their functions effectively, internal auditors must possess an appropriate level of professional qualification, technical proficiency and skills, and knowledge about the AI's business and risks. The IAF should ensure that as a whole it possesses the required knowledge, skills and other competences to perform all assignments and examine all areas in which the AI operates.
- 3.4.4 Internal auditors must have the ability to keep pace with, and understand, the risks emerging from rapid financial innovations and developments (e.g. in the form of high risk or complex, structured products), as well as the skills and methodologies to evaluate the robustness of systems and controls for managing the associated risks, including the assessment of risk models or metrics used.

### 3.5 Continuity



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- 3.5.1 Each AI should have a permanent IAF that is adequately manned by staff members with sufficient experience and expertise.
- 3.5.2 To minimise potential disruptions in the event that key personnel should leave the IAF, and to achieve continuity in consistent application of audit procedures and standards, it is important for adequate documentation to be maintained.
- 3.5.3 In particular, all staff members of the IAF should be given an audit manual which documents, among other things, the audit charter, as well as all internal audit policies, work processes and standards. Any subsequent changes to the manual and the rationale behind such changes should be properly recorded and communicated to the staff members.
- 3.5.4 A written track record should also be maintained for all audit work performed, audit recommendations, responses of the audited parties, and the subsequent audit reports and processes for finalising and implementing the audit recommendations. Any decision which overrides any aspect of the recommendations of the IAF should be supported by adequate written justifications.
- 3.5.5 Whenever the Head of IAF ceases to act in this capacity, the AI concerned should inform the HKMA in a timely manner of the fact and of the circumstances appertaining to the change in personnel. The HKMA may consider meeting with the outgoing Head of IAF after he has been relieved of his duties.

## 4. Work process of internal audit function

### 4.1 General

- 4.1.1 AIs are expected to have a structured process for performing internal auditing work, with well-defined stages to ensure that the auditing work is prioritised around the most material and relevant risks, and that internal control weaknesses can be effectively identified and addressed in a timely manner.
- 4.1.2 The work process should include devising an audit plan, drawing up an audit programme for each assignment under the audit plan, performing and documenting audit



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work procedures, reporting audit findings and following up recommendations.

### 4.2 Audit plan

- 4.2.1 An audit plan should document all audit assignments to be performed, establishing their priority, timing and frequency. It should also set out the manpower and financial resources required to achieve the audit assignments within a realistic time frame. An audit plan may span a few years depending on the activities to be examined.
- 4.2.2 The audit plan should be established by the IAF and approved by the Board (or the Audit Committee).
- 4.2.3 The extent, nature and frequency of the audit assignments to be performed should be risk-focused and driven by the results of a comprehensive assessment conducted by the IAF of the risks inherent in all significant activities of an AI (and its subsidiaries) or likely to emerge from expected developments and innovations, particularly from new activities which generally carry a higher degree of risk, and of the internal control systems for managing those risks. The risk assessment criteria should include quantitative and qualitative factors.
- 4.2.4 The principles for the risk assessment methodology should be established in writing by the IAF and regularly updated to reflect changes to the system of internal controls or work processes and to incorporate new lines of business.
- 4.2.5 All activities of an AI, including those undertaken by its branches and subsidiaries (whether banking or non-banking), should be subject to the IAF's scope of review. In conducting its review, the IAF should not limit itself to auditing specific units or departments, but should also pay attention to auditing specific activities conducted by different units or departments.

### 4.3 Audit programme

- 4.3.1 For each audit assignment, the IAF should prepare an audit programme to clearly set out –
- the objectives that the assignment plans to achieve;
  - the scope of the assignment in relation to which business or functional units will be involved and the



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areas of their internal control procedures to be examined;

- the audit methodologies to be adopted for the assignment. Common methodologies include enquiries with management, analytical reviews, walk-through procedures, external confirmations and sample testing;
- the parties to whom the audit report should be communicated;
- the schedule for field work and issuance of reports. Particularly for larger assignments, it will be useful to develop a form of Gantt chart illustrating the time span for various activities individually to facilitate planning and monitoring of work; and
- the budget for manpower and other resources required for the assignment.

### 4.4 Audit procedures

4.4.1 All audit work procedures performed should be documented in working papers. These papers constitute the basis for drafting the audit report and should contain sufficient evidence to support the opinion formed.

4.4.2 Internal audit staff should realise that their working papers are formal evidence of their work and may be subject to rigorous review and queries by internal or external parties including the HKMA. The working papers must therefore be –

- legible, organised and readily available upon request, and only information that is relevant to achieving the audit objective should be included;
- drawn up according to a well-determined method (e.g. use of suitable indexes and cross-references) to facilitate subsequent review; and
- able to reflect that the auditing work has been duly performed and provide an audit trail for checking how the work has been performed.

### 4.5 Audit reporting

4.5.1 A draft report presenting the scope and purpose of the audit assignment, as well as the preliminary audit findings and recommendations in respect of any internal control



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weaknesses identified, should be issued to the management of the audited line of business or operations for comments before the final report is prepared. This will provide the internal auditors and the relevant management with an opportunity to exchange views and comments on the audit findings so as to avoid any misunderstanding or misinterpretation about the findings before the report is formally issued.

4.5.2 In the case of disagreement between the management and the internal auditors in respect of any important findings or recommendations included in the draft report that cannot be resolved, the IAF should retain in the final report such findings or recommendations, include reference to the different views presented by the management, and submit the report to senior management and the Board (or the Audit Committee) for their consideration and further action.

4.5.3 As quickly as practicable, a final report of the audit assignment should be issued to the management of the audited line of business or operations, senior management and the Board (or the Audit Committee), incorporating the responses from the relevant management on the findings and recommendations, as well as the agreed action plan which outlines the remedial measures to be taken to address the internal control weaknesses identified, their target completion dates, and the responsible parties for carrying out the remedial measures.

4.5.4 At any time during the audit assignment, the IAF should consider the necessity of issuing an interim report to the relevant management, or if necessary also to senior management and the Board (or the Audit Committee) where, for instance, serious issues are identified that should be brought to their immediate attention, or the audit assignment extends over a relatively long period.

### 4.6 Follow-up procedures

4.6.1 The principal responsibility for implementing remedial measures to address internal control weaknesses identified by the IAF should rest with the management of the audited line of business or operations.



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4.6.2 The IAF should conduct follow-up reviews with the relevant management on a regular basis to monitor the implementation progress and report the results periodically (say, every half-year) to senior management as well as the Board or the Audit Committee (or to the group IAF in the case of the local IAF of a foreign bank branch or subsidiary). The follow-up report should highlight, among other things –

- any areas of delay according to the agreed action plan;
- any remedial measures that have not been properly implemented; or
- any remedial measures that are found after implementation to be ineffective in addressing the internal control weaknesses identified, together with further proposed actions to address the weaknesses.

## 5. Relationship with compliance function and external auditors

### 5.1 General

5.1.1 The activities of the compliance function and the external auditors of an AI are closely related to the work of the IAF in assessing whether the AI has adequate internal control systems in place for managing risks. The IAF may, where appropriate, leverage on the work performed by the compliance function and the external auditors in various stages of its auditing work, and should wherever possible minimise any duplication of work involved.

### 5.2 Compliance function

5.2.1 The main responsibilities of the compliance function of an AI are to monitor changes and developments of relevant laws, regulations and standards applicable to the AI's banking and regulated activities and ensure that its senior management and relevant business and functional units are aware of such changes and developments and take appropriate measures to achieve compliance. The purview of the compliance function includes primary legislation and rules, standards and guidelines issued by regulators, market conventions and codes of practice



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promoted by industry associations, and internal policies and codes of conduct applicable to staff members.

5.2.2 Structurally, the compliance function should be separate from, and subject to the independent review of, the IAF. Unlike the IAF, which reports directly to the Board (or the Audit Committee) of an AI, the compliance function normally reports to the AI's senior management.

5.2.3 In conducting its audit on the compliance function, the IAF should examine whether the systems and procedures in place for ensuring compliance with the relevant laws, regulations and standards are adequate. The work performed by an effective compliance function provides the IAF with a valuable source of information for the identification of any deficiencies in an AI's internal control and compliance systems.

### 5.3 External auditors

5.3.1 External auditors appointed by an AI to comply with requirements under the Banking Ordinance or under the Companies Ordinance or otherwise have an important role to play in the ongoing enhancement of the AI's internal control systems in that system or control deficiencies could be uncovered in the course of conducting their work.

5.3.2 The work of the external auditors should complement that of the IAF and vice versa. The Board (or the Audit Committee) should ensure that a mechanism is in place for the external auditors and the IAF to keep each other informed of any significant matters of concern identified that may affect the work of the other. Coordination of auditing efforts may involve periodic meetings to discuss matters of mutual interest, the exchange of audit reports and management letters, and a common understanding of auditing techniques, terminology and methods employed.

5.3.3 The Board may also consider commissioning external auditors or other qualified independent reviewers to perform a comprehensive check specifically on the operations of the IAF, on a periodic or need basis, to introduce or transfer knowledge of leading techniques and practices for internal controls, risk management and internal auditing, in order to enhance the efficiency and



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effectiveness of the IAF, in the face of the ever-changing market environment in which the AI operates, and its involvement in new business activities and financial products.

### 5.4 Internal control departments

5.4.1 Some AIs have established separate internal control departments within business or functional units to monitor and assess compliance of specific activities with the internal control and compliance standards. There are also AIs which require individual business or functional units to conduct regular self-assessments to ensure that operational and control procedures are properly followed. Such mechanisms are part of the internal control systems and their existence therefore does not relieve the IAF from examining the internal controls of the specific activities to ensure that they are functioning adequately. However, if conducted effectively, these mechanisms provide a useful source of information that the IAF and the compliance function could make use of for the ongoing monitoring of how well relevant activities are being managed and controlled.

## 6. Outsourcing of internal audit function

### 6.1 General

- 6.1.1 An AI may in some circumstances consider it necessary to outsource its IAF, in whole or in part, to an external party which provides internal auditing services. Outsourcing (on a limited or targeted basis) can bring significant benefits to AIs such as access to specialised expertise and knowledge for a special audit project otherwise not available within the organisation. However, outsourcing may also give rise to the risks of losing or reducing controls over the outsourced internal auditing activities, which the AI concerned needs to manage and monitor closely.
- 6.1.2 AIs which intend to outsource the IAF or to change the scope of existing outsourcing arrangements, in whole or in part, should discuss their plans with the HKMA in advance and provide sound justifications.
- 6.1.3 It should however be emphasised that regardless of whether internal auditing activities are outsourced, the



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Board remains ultimately responsible for ensuring that the internal control systems are subject to adequate independent assessment.

### 6.2 Full or partial outsourcing

6.2.1 Generally, the HKMA would normally only permit the outsourcing of the internal audit of an AI's entire operations under very limited circumstances, an example being that the AI's operations are so small and simple that the maintenance of a full-scope internal audit team in Hong Kong is not justified. In such cases, it may still be necessary for the AI to maintain a small IAF or, if that is not practicable, the AI should at least designate a senior and experienced individual to liaise with the outsourcing vendor on the internal auditing work to be performed and to follow up on audit findings and the rectification of weaknesses identified. In the case of foreign bank branches and subsidiaries, any outsourcing arrangement should not preclude the group IAF from conducting audits on the Hong Kong operations.

6.2.2 The HKMA would normally expect AIs, where necessary, to outsource only certain audit assignments which, for instance, the IAF is not sufficiently proficient in conducting. AIs are however encouraged to see to it that whenever practicable, the knowledge of the external expert is eventually integrated into the IAF, possibly by having one or more than one staff member of the IAF participating in the work of the expert.

### 6.3 Criteria for outsourcing

6.3.1 Set out below are some factors that the HKMA will have regard to in considering whether the outsourcing arrangement is acceptable from a supervisory point of view.

- To preserve independence, the HKMA would prefer an AI to outsource its IAF to a firm other than its existing external auditors.
- The AI should perform due diligence to satisfy itself that the outsourcing vendor is a competent, financially sound firm with sufficient knowledge, resources and expertise in the relevant areas.
- The outsourcing contract should be in written form –



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- defining the outsourcing vendor's assignments and responsibilities;
  - making it a requirement for senior management to be consulted on the risk analyses to be performed and the audit plan to be established;
  - providing senior management or its representative(s), the external auditors, and the HKMA with access at any time to the outsourcing vendor's records relating to the vendor's audit plan, audit assignments and working papers, etc; and
  - requiring the vendor to commit adequate resources to effectively perform the required assignments under the audit plan, with a protocol for changing the terms of the contract, especially for expansion of auditing work if significant issues are found.
- Other relevant supervisory standards included in SA-2 "Outsourcing" should be satisfied.

6.3.2 AIs with outsourced internal auditing activities are also expected to analyse the impact such outsourcing will have on their overall risk profile and internal control systems. In case the outsourcing arrangement should suddenly terminate, the AI concerned should have a contingency plan for replacing the vendor. Given the lead time for appointing a suitable vendor, the AI may need to consider whether to increase its own internal auditing efforts temporarily.

### 6.4 Reporting arrangements

6.4.1 Communication between the IAF and the Board (or the Audit Committee) and senior management (and also between the local IAF and the group IAF in the case of foreign bank branches and subsidiaries) should not diminish in respect of any audit assignment outsourced.

6.4.2 The IAF should be responsible for the results of the outsourced auditing work, including findings, conclusions and recommendations. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the IAF.



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- 6.4.3 The IAF should in turn, after consultation with the management of the audited line of business or operations, report the findings of the vendor, together with its comments, to the Board (or the Audit Committee) and senior management (and also the group IAF in the case of the local IAF of a foreign bank branch or subsidiary), where appropriate.
- 6.4.4 In cases where an AI has not maintained an IAF after outsourcing all of its internal auditing activities, there should be an individual designated by the AI (as referred to in para. 6.2.1) for handling communication matters between the vendor and the Board (or the Audit Committee) and senior management (and also the group IAF in the case of a foreign bank branch or subsidiary).

## 7. Supervisory assessment of internal audit function

### 7.1 General

- 7.1.1 Under its risk-based supervisory approach, the HKMA may, where appropriate, leverage on the work done by an IAF that is adequately resourced with sufficient expertise, standing and independence within an AI to facilitate its supervisory assessment of the AI's internal control systems and determine its scope of examination on the AI.
- 7.1.2 For locally incorporated AIs of which the HKMA is the home supervisor, the HKMA is directly responsible for reviewing the extent to which the relevant standards contained in this module are met by the AIs on a group-wide basis. In particular, the purpose of the HKMA's review is to ascertain whether the IAF of these AIs is effective given the nature and scale of their operations (including overseas operations in the form of branches or subsidiaries).
- 7.1.3 For branches and subsidiaries of foreign banks<sup>1</sup> operating in Hong Kong, the ultimate responsibility for assessing the effectiveness of the IAF on a group-wide basis rests with the bank's home supervisor. The HKMA's supervisory focus is on the part of the IAF

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<sup>1</sup> This also applies to any AI which is a subsidiary of a regulated financial holding company.



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covering the Hong Kong operations of such branches and subsidiaries. If a local subsidiary of a foreign bank has overseas operations, the IAF covering those operations will also be assessed.

### 7.2 Scope and means of assessment

7.2.1 The HKMA will determine the effectiveness of the IAF by evaluating the extent to which it can ensure that the internal risk management and control policies and processes are complied with, and continue to be sufficient and appropriate for an AI's existing businesses and planned business developments, if any. The HKMA will also assess whether the IAF is able to make suitable recommendations, where necessary, to improve the effectiveness of those policies and processes. However, the Board and senior management of the AI remain primarily responsible for ensuring that the standards of this module are met.

7.2.2 In its supervisory assessment of the effectiveness of the IAF, the HKMA will place special emphasis on whether the IAF –

- has sufficient resources, and staff who are suitably trained and have relevant skills, knowledge and experience to understand and evaluate the business they are auditing;
- has appropriate independence and authority, including reporting lines and status within the AI (or banking group), to ensure that senior management acts upon its recommendations adequately;
- has full and unfettered access to, including communication with, any member of staff as well as full and unfettered access to records, files or data of the AI and its affiliates, whenever relevant to the performance of its duties;
- employs a methodology that identifies the material risks run by the AI and prepares audit plans based on its own risk assessment and allocates its resources accordingly; and
- has the authority to assess any outsourced functions.



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7.2.3 The HKMA will assess the effectiveness of an AI's IAF in its ongoing supervision as part of its risk-based supervisory process normally through documentary review and appropriate contacts with the IAF, management and external auditors of the AI.

### 7.3 Documentary review

7.3.1 For the purpose of its documentary review, the HKMA will normally require AIs to provide (e.g. during off-site reviews or on-site examinations or on a need basis) documents and information for assessing the extent to which certain key determinants of an effective IAF exist. These include –

#### *Independence and authority*

- organisation chart showing the reporting line of the IAF;
- information on the structure and functions of the IAF;

#### *Expertise, resources and staff management*

- list of members (with organisational titles) in the Audit Committee, if any;
- qualifications and past experience of the staff members of IAF;
- frequency and rotational plan;

#### *Authority and documentation of policy and procedures*

- audit charter or other form of equivalent written mandate;
- internal audit policies and manual;

#### *Appropriateness of audit coverage and implementation of audit recommendations*

- current and coming year's audit plan covering all business or functional units subject to audit within the AI, including risk assessment and audit priorities of individual units or activities;
- internal audit programme, working papers and internal audit reports showing work done in the past 12 months and management responses to recommendations and follow-up actions;



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- current progress of work and reasons for deviations from the audit plan, if any;

### *Quality assurance*

- letters or reports from the external auditors or other supervisory authorities informing the management of significant weaknesses in the IAF and recommendations for improvement, if any. In the case of a local IAF of a foreign bank branch or subsidiary, this will include reports made by the group IAF; and
- minutes of meetings of the Audit Committee, if any.

## 7.4 Supervisory contacts

7.4.1 The HKMA will supplement documentary review with an interactive dialogue through meetings with parties relevant to maintaining the effectiveness of the IAF of an AI during its ongoing supervisory process. This will enable the HKMA to form a better assessment of how well the work of the IAF is being conducted or reviewed by the relevant parties involved. The meetings will include the following occasions:

- High-level meetings with the Board or the Audit Committee of locally incorporated banks on an annual basis to discuss, inter alia, risk management and internal control issues. In relation to the IAF, issues would cover the audit plan, latest changes to the structure of the IAF and audit procedures, the results of any independent review conducted by the Audit Committee on the IAF, etc;
- On-site examinations conducted during the normal cycle of the HKMA's risk-based supervisory process or to review specific areas of operations, during which the examination team of the HKMA will meet with the internal auditors to exchange views and ideas on such matters as audit coverage and frequency, weaknesses and major issues identified, progress on implementation of any audit recommendations and the mechanism for tracking progress etc, particularly in relation to areas to be examined in the on-site examinations;
- Prudential interviews with senior management of AIs, and their internal auditors, where necessary, following



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an off-site review to discuss issues of supervisory concern identified during the review, which may cover issues similar to those mentioned above for on-site examinations. Meetings with internal auditors may also be separately arranged whenever necessary to discuss internal control issues identified;

- Meetings with group internal auditors of foreign banks on their visit to audit their Hong Kong branches or subsidiaries, whether at the start of the audit (e.g. to discuss the audit coverage) or at the close of it (e.g. to discuss any issues identified in relation to the adequacy of the internal control systems or the effectiveness of the local IAF). The HKMA would also expect to receive a copy of the report formally issued after the visit;
- Tripartite meetings with external auditors (or an outsourcing vendor) to which any part of an AI's internal auditing work has been outsourced, or with external auditors who have been appointed by an AI to conduct special reviews (e.g. under section 59(2) of the Banking Ordinance) that include issues concerning the effectiveness of the IAF; and
- Bilateral meetings with home supervisors of the Hong Kong branches or subsidiaries of foreign banks in which such supervisors and the HKMA will, where necessary, exchange views on the effectiveness of the group IAF, and the local IAF.

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