



## **Supervisory Policy Manual**

**IC-2**

**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.

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### **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### **Previous guidelines superseded**

IC-2 "Internal Audit Function" (V.1) dated 14.07.09.

### **Application**

To all AIs.

### **Structure**

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### 1. Introduction

#### 1.1 Background

1.1.1 Paragraph 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 rapidly changing business environments 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. As noted in paragraph 7.3.3, the HKMA will have regular communication with an AI’s internal auditors or other relevant persons to discuss issues of interest, including but not limited to the IAF’s audit plan and its work and findings relating to the AI’s internal control processes.

#### 1.2 Application

1.2.1 Every AI is expected to maintain an IAF that is appropriate for the size, nature, scope and complexity of its operations. With the increasing trend of AIs diversifying their activities into different products and



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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.

- 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 standards in 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 standards in 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 AIs are expected to refer periodically to the latest professional standards and best practices published from time to time by professional bodies such as the Institute



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of Internal Auditors for further guidance on a more technical level.

## 2. Hierarchy of responsibilities

### 2.1 General

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.

### 2.2 Board of directors

2.2.1 The Board has the ultimate responsibility for ensuring that effective internal control systems and processes are in place given the size, nature, scope and complexity of an 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 a particular 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 processes at least once a year (or on a more frequent basis as necessary). Such review may be conducted by the Audit Committee as appropriate.



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2.2.2 In respect of internal audit specifically, the Board is primarily responsible for ensuring that the IAF is effective in performing an independent assessment of the adequacy 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 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 specifically, an AI's 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 on a timely basis 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



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- 2.4.1 An effective IAF assists the Board and senior management in the discharge of their responsibilities as described above by providing independent assessment and assurance on the AI's internal control systems. The IAF should regularly report to, and advise, the Board (or the Audit Committee) and senior management on the results of its assessments (see subsection 4.5 for relevant reporting standards).
- 2.4.2 The IAF is accountable to the Board (through the Board's Audit Committee) and its key responsibilities should include conducting independent assessments of the:
- compliance with internal policies and risk management controls as well as relevant laws, regulations, and supervisory guidelines;
  - reliability (including integrity, accuracy and comprehensiveness) and timeliness of financial and management information (including information for regulatory reporting);
  - continuity and reliability of management and financial information systems, including electronic information systems (for internal and regulatory reporting);
  - effectiveness of the control environment supporting the accuracy of accounting records, regulatory reports and management reports;
  - efficiency of operations through testing of both transactions and the functioning of specific internal control procedures; and
  - effectiveness of the systems and processes for internal 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 –



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- have the organizational stature, skills, knowledge and authority necessary to lead the IAF in providing reliable and independent assessments of the quality and effectiveness of the AI's internal control systems;
- ensure that the IAF complies with sound internal auditing standards and relevant codes of ethics<sup>1</sup>;
- establish an audit charter, an audit plan, and written policies and procedures to be followed 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 and the Board (or the Audit Committee (see section 2.5)).

### 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 establish an Audit Committee to assist the Board 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 of the Audit Committee).

2.5.2 The Board is expected to delegate to the Audit Committee 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;

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<sup>1</sup> For example, International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA) and the code of ethics issued by IIA and the International Ethics Standards Board for Accountants.





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- monitor the AI's financial reporting process and relevant output, including arrangements through which concerns about possible improprieties in matters of financial reporting can be raised;
- oversee the establishment of the AI's accounting policies and practices (including quality of accounting estimates and disclosures) and review significant judgements made in financial reporting within the AI's financial statements;
- appoint (or make recommendations to the Board regarding the appointment of) the Head of IAF;
- 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 related manpower and financial resources required after identifying the areas of risk within the AI's operations to be covered;
- review the performance of the Head of IAF and the effectiveness of the IAF;
- review reports and significant recommendations provided by the IAF and management plans for their implementation;
- make recommendations to the Board with regard to the appointment of the AI's external auditors and related matters (e.g. terms of engagement and remuneration) and oversee the work of the external auditors (e.g. 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 the progress made by the senior management in implementing any remedial actions to address deficiencies identified in the AI's internal control systems (including those identified by internal and external auditors, the Audit Committee itself or the HKMA); and
- provide opportunities for external and internal auditors to meet and discuss their respective findings.



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- 2.5.3 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 an AI's business and functional units (including units undertaking other internal control functions) that are subject to its review. The Head of the IAF should not have management responsibility related to such business and functional units of the AI.
- 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 to the local management.
- 3.1.4 The IAF should be subject to independent review, which can be carried out by independent parties such as external auditors or other qualified independent reviewers, or by the Audit Committee. Such review should aim to evaluate the effectiveness of the IAF and, where necessary, provide recommendations to improve its effectiveness. Reviews should be conducted regularly and cover all major aspects of the IAF's work.

#### 3.2 Authority and standing

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



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3.2.2 Each AI should therefore have an audit charter to articulate the purpose, 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, at a minimum, should establish –

- the objectives and scope of the IAF;
- the IAF's position within the organisation, its powers, responsibilities and relations with other internal control units;
- the accountability of the Head of IAF; and
- 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 with any member of staff, to examine any activity of the AI, and to access any records, files, data or properties of the AI, including management information systems and records and the minutes of the AI's consultative and decision-making bodies, whenever relevant to the IAF's assignments.

### 3.3 Objectivity and impartiality

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 units 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 (or any longer "cooling-off" period as appropriate);



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- the Head of IAF should request the audit staff to declare, and seek to mitigate as far as practicable, any possible conflict of interest (e.g. the head or any 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;
- for a locally incorporated AI, matters such as the annual remuneration of the Head of IAF and of the IAF as a whole<sup>2</sup> and budgeted resources of the IAF should be reviewed and approved by the Board or its relevant delegated committee (i.e. the Audit Committee or Remuneration Committee). Where such matters are considered by a committee of the Board, if any members of the committee have a conflict of interest (e.g. because they are from departments that are subject to oversight by the IAF), such matters should be discussed in the committee meetings absent these members; and
- an AI incorporated outside Hong Kong should follow its established internal policies to review and approve the remuneration of the IAF in the Hong Kong branch. The AI should take responsible steps to mitigate conflicts in determining such remuneration.

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 commencement of

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<sup>2</sup> For the avoidance of doubt, annual remuneration would include any variable incentives-based remuneration.



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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 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, nature, scope and complexity of the AI's operations. For example, the availability of skills and the knowledge and 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 activities 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



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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

- 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 is appointed or ceases to act in this capacity, the AI concerned should inform the HKMA in a timely manner with relevant information (e.g. qualification of the new appointee and the circumstances appertaining to the change in personnel), and make public disclosure. 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



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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. Internal auditors should adhere to applicable ethical and professional standards in performing their work (including acting with integrity, respecting confidentiality of information and avoiding conflict of interest).

- 4.1.2 The work process should include at least the following stages: devising an audit plan, drawing up an audit programme for each assignment under the audit plan, performing and documenting audit 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. If an audit plan spans a few years, it should be reviewed and updated at least annually.
- 4.2.2 The audit plan should be established by the IAF and approved by the Board (or the Audit Committee). It should cover reviews or assessments of key risk management functions, regulatory capital adequacy and liquidity control functions, regulatory and internal reporting functions, compliance function and finance function. There should also be adequate coverage of matters of regulatory interest, including policies, processes and governance measures established in response to various regulatory principles, rules and guidance established by the HKMA and any other relevant authorities.
- 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



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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 or across 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 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





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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 clearly understand that their working papers are formal evidence of their work and may be subject to rigorous review and query 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 weaknesses identified, should generally be issued to the management of the audited business or functional units 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.



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- 4.5.3 As soon as practicable, a final report in respect of the audit assignment should be issued to the management of the audited business or functional units, 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 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 During the course of the audit assignment, the IAF should retain the option to issue, and 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.
- 4.5.5 In addition to the above, the IAF should provide regular reports to the Board (or the Audit Committee), summarising the results of the IAF's work, including overall conclusions or assessments, key findings, material risks and issues, and follow-up of management's resolution of identified issues. Simply reporting that certain audit reports have been completed may be insufficient to assist the Board to carry out its responsibilities effectively.

### 4.6 Follow-up procedures

- 4.6.1 The principal responsibility for implementing timely and effective remedial measures to address internal control weaknesses identified by the IAF should rest with the management of the audited business or functional units.
- 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 –



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- any areas of delay according to the 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 risk management and compliance functions and external auditors

#### 5.1 Risk management and compliance functions

5.1.1 Structurally, the risk management and compliance functions should be separate from, and subject to the independent review of, the IAF. The main responsibilities of an AI's risk management function include ensuring that all relevant risks of the AI are properly identified, well understood, measured, controlled, assessed and reported, whereas the compliance function is responsible for identifying, assessing, monitoring and reporting and advising on compliance risk in respect of legislation, rules, standards and guidelines issued by regulators, and codes of practice promoted by industry associations applicable to the AI as well as internal policies and codes of conduct applicable to staff members.

5.1.2 The work performed by the independent risk management and compliance functions provides the IAF with a valuable source of information for the identification of any deficiencies in an AI's internal control systems.

5.1.3 Some AIs have established separate internal control processes within business or functional units to monitor and assess compliance of specific activities with 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. The existence of such mechanisms does not relieve the IAF from the responsibility of examining the internal controls related to the specific activities to ensure that they are functioning adequately. However, if conducted effectively, these mechanisms may provide a useful



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source of information that the IAF and the compliance function can make use of for the ongoing monitoring of how well relevant activities are being managed and controlled.

### 5.2 External auditors

5.2.1 External auditors appointed by an AI (to comply with requirements under the Banking Ordinance or the Companies Ordinance or otherwise) have an important role to play in the ongoing enhancement of the AI's internal control systems insofar as system or control deficiencies may be uncovered in the course of the conduct of their work.

5.2.2 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.

5.2.3 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. This should serve to introduce or transfer knowledge of techniques and practices for internal controls, risk management and internal auditing, in order to enhance the efficiency and effectiveness of the IAF, in the face of the changing market environment in which the AI operates or in relation to its involvement in new business activities and financial products.

## 6. Outsourcing of internal audit function

### 6.1 General

6.1.1 This section refers to outsourcing the IAF to an external party. It should be read in conjunction with section 2 of the Supervisory Policy Manual module SA-2 on Outsourcing for details of the outsourcing process.



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- 6.1.2 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.
- 6.1.3 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.
- 6.1.4 It should however be emphasised that regardless of whether internal auditing activities are outsourced, the 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 only regard as acceptable the outsourcing of the internal audit of an AI's entire operations under very limited circumstances. An example would be 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 service provider 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 only to outsource certain specific audit assignments where necessary because, for instance, the IAF is not sufficiently proficient or resourced to conduct them. In any such case, AIs are however encouraged to see to it that whenever



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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.

- It is important to ensure that any third party service providers to which the IAF activities are outsourced can carry out the tasks independently. For this reason, the HKMA generally expects that AIs will not outsource to its existing external auditors, or to a service provider that has been involved in the area to be outsourced before a reasonable cooling off period has expired. If an AI reasonably considers that it is not practical to identify any service provider which can meet this general expectation, or that there are strong justifications for engaging a service provider for a given outsourced IAF arrangement in deviation from this general expectation, the AI should properly document its assessment (including any potential conflict of interest threatening independence and the institution of any compensating safeguards). It should stand ready to provide detailed justification of its decision upon request by the HKMA.
- The AI should perform due diligence to satisfy itself that the service provider is a competent, financially sound firm with sufficient knowledge, resources and expertise in the relevant areas.
- The outsourcing contract should be in written form –
  - defining the service provider'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 service



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provider's records relating to the service provider's audit plan, audit assignments and working papers, etc;

- requiring the service provider to adhere to applicable professional standards and codes of ethics; and
- requiring the service provider 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 audit activities are expected to assess the impact of such outsourcing on their overall risk profile and internal control systems. AIs should have a contingency plan for replacing a service provider in the event of a sudden termination of an outsourcing contract. Having regard to the lead time for appointing a suitable service provider as replacement, the AI may need to consider increasing its own internal auditing efforts in the interim.

### 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 which is 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 service provider should be well documented and all findings of control weaknesses should be promptly reported to the IAF.

6.4.3 The IAF should in turn, after consultation with the management of the audited business or functional units, report the findings of the service provider, together with its comments, to the Board (or the Audit Committee) and senior management (and also the group IAF in the case



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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 noted in paragraph 6.2.1) for handling communications between the service provider 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>3</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 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.

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<sup>3</sup> This also applies to any AI which is a subsidiary of a regulated financial holding company.





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### 7.2 Scope 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 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. The HKMA's supervisory assessment is not a substitute for the AI's internal or external assessments on the efficacy of the IAF.

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, data or properties 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.

### 7.3 Means of assessment



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

7.3.2 For the purpose of its documentary review, the HKMA will normally require an AI to provide (e.g. during off-site reviews or on-site examinations or on a need basis) documents and information for the purpose of 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 Head of IAF and staff members of IAF;
- frequency of and plan for staff rotation in the IAF;

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



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### *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
- documents and reports submitted by the IAF to the Audit Committee, and minutes of meetings of the Audit Committee, where an Audit Committee is established (see paragraph 2.5.1 for expectations regarding the establishment of an Audit Committee).

7.3.3 The HKMA may supplement documentary review with interactive dialogue with any party the HKMA considers relevant to maintaining the effectiveness of the IAF of an AI. 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. Such dialogue may be conducted on 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, any recent changes to the structure of the IAF or to audit procedures, the results of any independent review conducted by the Audit Committee on the IAF, etc;
- On-site examinations during which the HKMA's examination team will meet with the internal auditors to exchange views and ideas on matters such 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 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



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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 service provider(s)) 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) relating in whole or in part to issues concerning the effectiveness of the IAF; and
- Bilateral meetings with the home supervisors of foreign banks with branches or subsidiaries in Hong Kong, in which such supervisors and the HKMA will, where necessary, exchange views on the effectiveness of the IAF at the local and group levels.

### 7.4 Supervisory actions

7.4.1 If the HKMA becomes aware of deficiencies in an AI's IAF, it will draw them to the attention of the AI's Board and senior management, and discuss measures to urgently address the situation. The AI should keep the HKMA informed of the progress in implementing any necessary remedial actions.

7.4.2 Deficiencies in the AI's IAF and implementation of the necessary remedial actions will be taken into account in the HKMA's supervisory review process and/or determination of the CAMEL rating in respect of the AI. In more serious cases, deficiencies in an AI's IAF may call into question whether the AI continues to satisfy the minimum criteria for authorization in the Banking Ordinance and cast doubt on the fitness and propriety of the AI's directors and senior management.



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