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## INDEPENDENT ASSURANCE REPORT

### TO THE MANAGEMENT OF THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED – SRI LANKA BRANCH

We were engaged by the Management Committee of Hongkong and Shanghai Banking Corporation Limited – Sri Lanka Branch (“the Bank”) to provide assurance on the Head Office Statement on Internal Control (“the Statement”) for the year ended 31<sup>st</sup> December 2014.

#### Management’s responsibility for the Statement on Internal Control

Management is responsible for the preparation and presentation of the Statement in accordance with the “Guidance for Directors of Banks on the Directors’ Statement of Internal Control” issued in compliance with the section 3(8)(ii)(b) of the Banking Act Direction No. 12 of 2007, by the Institute of Chartered Accountants in Sri Lanka.

#### Scope of the engagement in compliance with SLSAE 3050

Our responsibility is to issue a report to the Management on the Statement based on the work performed. We conducted our engagement in accordance with Sri Lanka Standard on Assurance Engagements SLSAE 3050– Assurance Report for Banks on Directors’ Statement on Internal Control issued by the Institute of Chartered Accountants of Sri Lanka.

#### Summary of work performed

Our engagement has been conducted to assess whether the Statement is both supported by the documentation prepared by or for Management and appropriately reflects the process the Management has adopted in reviewing the system of internal control for the Bank.

To achieve this objective, appropriate evidence has been obtained by performing the following procedures:

- (a) Enquired the Management to obtain an understanding of the process defined by the Management for their review of the design and effectiveness of internal control and compared their understanding to the Statement made by the Head office.
- (b) Reviewed the documentation prepared by the Management to support their Statement made.
- (c) Related the Statement made by the Management to our knowledge of the Bank obtained during the audit of the Financial Statements.
- (d) Reviewed the minutes of the meetings of the Executive Committee and the Asset and Liability Committee.
- (e) Considered whether the Head Office Statement on Internal Control covers the year under review and that adequate processes are in place to identify any significant matters arising.
- (f) Obtained written representations from the Management on matters material to the Statement on Internal Control where other sufficient appropriate audit evidence cannot reasonably be expected to exist.



SLSAE 3050 does not require us to consider whether the Statement covers all risks and controls, or to form an opinion on the effectiveness of the Branch's risk and control procedures. SLSAE 3050 also does not require us to consider whether the processes described to deal with material internal control aspects of any significant problems disclosed in the financial statements will, in fact, remedy the problems.

**Our conclusion**

Based on the procedures performed nothing has come to our attention that causes us to believe that the Statement is inconsistent with our understanding of the process the Management has adopted in the review of the design and effectiveness of internal control system over the financial reporting of the Bank.

A handwritten signature in blue ink, appearing to read 'KPMG'.

**Chartered Accountants**

21<sup>st</sup> May 2015

Colombo

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED**  
**SRI LANKA BRANCH**  
**HEAD OFFICE STATEMENT ON INTERNAL CONTROLS**

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**RESPONSIBILITY**

The Hong Kong & Shanghai Banking Corporation Limited – Sri Lanka Branch ('HSBC Sri Lanka') is registered in Sri Lanka as a branch of The Hong Kong and Shanghai Banking Corporation Limited ('the Company'), a company incorporated in Hong Kong, and as such follows all policies and procedures laid out by the Company. HSBC Holdings plc, a company incorporated in England, is the ultimate holding company.

In line with the Banking Act Direction No. 11 of 2007, Section 3 (8) (ii) (b), and the subsequent circular 02/17/550/002/002 dated 3rd January 2011, the Head of the Office supervising HSBC Sri Lanka, namely HSBC International, presents this Report on Internal Control.

HSBC International, together with the regional teams of Global Businesses and Global Functions ("collectively the "Head Office"), are responsible for the adequacy and effectiveness of the system of internal controls at HSBC Sri Lanka ('the Bank'). Such a system is designed to manage the Bank's key areas of risk within an acceptable risk profile, rather than to eliminate the risk of failure to achieve the policies and business objectives of the Bank. Accordingly, the system of internal controls can only provide reasonable but not absolute assurance against material misstatement of management and financial information and records or against financial losses or fraud.

The Head Office has established an ongoing process for identifying, evaluating and managing the significant risks faced by the Bank and this process includes enhancing the system of internal controls as and when there are changes to the business environment or regulatory guidelines. The process is regularly reviewed and has further considered the Guidance for Directors of Banks on the Directors' Statement on Internal Control issued by the Institute of Chartered Accountants of Sri Lanka taking into account principles for the assessment of internal control systems as given in that guidance.

The Head Office is of the view that the system of internal controls in place is sound and adequate to provide reasonable assurance regarding the reliability of financial reporting, and the preparation of Financial Statements for external purposes has been done in accordance with Sri Lanka Accounting Standards and regulatory requirements of the Central Bank of Sri Lanka.

The Chief Executive Officer ("CEO") and the Executive Committee ("EXCO") of HSBC Sri Lanka, together assist the Head Office in the implementation of policies and procedures on risk and control by identifying and assessing the risks faced, and in the design, operation and monitoring of suitable internal controls to mitigate and control these risks.

**KEY PROCESSES ADOPTED AND APPLIED IN REVIEWING THE DESIGN AND EFFECTIVENESS OF THE INTERNAL CONTROL SYSTEM ON FINANCIAL REPORTING**

The key processes that have been established in reviewing the adequacy and integrity of the system of internal controls with respect to financial reporting include the following:

Various Committees have been established to ensure the effectiveness of the Bank's daily operations and that the Bank's operations are in accordance with the corporate objectives, strategies and the annual budget as well as the policies and business directions that have been approved.

It is the responsibility of Management at all levels to ensure that effective internal controls are in place for all operations for which they are responsible. Our Global Businesses are the Risk Owners. They are accountable and responsible for managing risk in their day-to-day activities through processes and controls. Control Owners exist in Global Businesses, Global Functions and Operational areas. They are required to monitor and provide an opinion on the effectiveness of the controls relied upon by the Risk Owners to manage their risks. The Risk Owners and Control Owners ensure all key risks are identified, mitigated and monitored by an appropriate control environment. In addition, local Internal Audit ensures that staff adheres to documented policies and procedures, through internal control reviews.

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The primary role of Global Internal Audit (GBL INA) is to help the Board and Executive Management to protect the assets, reputation and sustainability of the HSBC Group. GBL INA provides independent and objective assurance as to whether the design and operational effectiveness of the Group's framework of risk management, control and governance processes, as designed and represented by management, is adequate. It also assesses the risk appetite globally/regionally and whether controls are designed and operated within those appetites. It places a degree of reliance on the effectiveness of the work completed by the Local Internal Audit team. The outcome is a holistic and timely view of how effectively the material risks within the Group are being managed.

Local Senior Management ensures compliance with policies and procedures and where there has been a breakdown in internal controls, or breach of authority, the CEO is advised in a timely manner. Additionally, such issues are escalated and tabled at the monthly Risk Management Committee (RMC) meeting. Where the CEO deems the issue material, it is reported up the functional and management lines to Regional Functions and GBL INA.

The Group Audit Committee ('GAC') is responsible for advising the Board on the effectiveness of our systems of internal controls and compliance in relation to financial matters and on meeting financial reporting obligations. The GAC also has responsibilities in relation to risk governance and oversight and internal controls. Regular reports are provided to the Board, the Group Audit Committee, the Group Risk Committee on credit exposures and the loan portfolio, asset, liability and risk management, liquidity, litigation and finance, compliance and reputational issues. The agenda and supporting papers are distributed in advance of all Board and committee meetings to allow time for appropriate review and to facilitate full discussion at the meetings. All Directors of the Company have full and timely access to all relevant information and may take independent professional advice if necessary.

Group Internal Audit provides independent assurance to management and the Group Risk and Audit Committees that HSBC's risk management, governance and internal control processes are operating effectively. The purpose, authority, and responsibility of audit units has been formally defined in a charter, consistent with the Definition of Internal Auditing and Code of Ethics and IIA Standards, and approved annually by either the Board of Directors or the Group Audit Committee.

The scheduling of audits is an on-going dynamic process reflecting changes in internal audit's assessment of the inherent risk of the auditable entities within the audit population. The Risk Calculator is used for decisions on the scheduling of audits by seeking to identify and measure entity level risks across the audit population to determine the prioritization of audit visits and to enable audit resources to be directed to the most appropriate areas. Audits are conducted on a risk-based approach particularly where the Bank has its own internal control function, where Group Audit can rely on the work undertaken locally.

Local Internal Audit is primarily responsible to:

- \* Provide independent and objective assurance as to whether the design and operational effectiveness of the Group's framework of risk management, control and governance processes, as designed and represented by management, is adequate.
- \* Focus on key risks across the Bank and assess the effectiveness of primary and secondary controls.
- \* Implement Audit coverage through a combination of governance and Internal audits.
- \* Assess the control risk and management's effectiveness in identifying, assessing and remediating control issues and risks within their area of responsibility.
- \* Monitor implementation and compliance with policies and procedures relating to operational risk and internal control.

The comments made by the external auditors and the internal audit department in connection with internal control system in the financial year to 31st December 2013 were reviewed during the year and appropriate steps have been taken to rectify them. The recommendations made by the external auditors and the internal

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audit department in the financial year to 31st December 2014 in connection with the internal control system have already been dealt with and in some instances are in the process of being actioned upon. Specifically, the controls with regard to the timely capitalization and depreciation of property, plant and equipment will be strengthened in the ensuing year. The Management is of the opinion that these recommendations are intended to further improve the internal control system and they do not in any way detract from the conclusion that the financial reporting system is reliable to provide reasonable assurance that the financial statements for external use are true and fair and comply with Sri Lanka Accounting Standards (SLFRS & LKAS) and the regulatory requirements of the Central Bank of Sri Lanka (CBSL).

**CONFIRMATION**

Based on the above, the Head Office confirms that the financial reporting system of the Bank has been designed to provide reasonable assurance regarding the reliability of financial reporting and that the preparation of Financial Statements for external purposes has been done in accordance with Sri Lanka Accounting Standards and regulatory requirements of the Central Bank of Sri Lanka.

**REVIEW OF THE STATEMENT BY EXTERNAL AUDITORS**

The External Auditors have reviewed the above Head Office Statement on Internal Control of the Bank for the year ended 31st December 2014 and reported to the Bank that nothing has come to their attention that causes them to believe that the statement is inconsistent with their understanding of the process adopted by the Management in the review of the design and effectiveness of the internal control system over financial reporting of the Bank.

By order of HSBC International,  
The signatories for the bank

Jayant Rikhye  
(Signed) Head of International Asia Pacific  
Head of Strategy and Planning Asia Pacific

Patrick J Gallagher  
(Signed) Chief Executive Officer Sri Lanka and  
Maldives

Date: 21 MAY 2015

**THE HONGKONG AND SHANGHAI BANKING CORPORATION LIMITED**  
**SRI LANKA BRANCH**  
**STATEMENT OF COMPLIANCE**

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The Hongkong & Shanghai Banking Corporation Limited – Sri Lanka Branch ('HSBC Sri Lanka') is registered in Sri Lanka as a branch of The Hongkong and Shanghai Banking Corporation Limited ('the Company'), a company incorporated in Hong Kong. HSBC Holdings plc, a company incorporated in England, is the ultimate holding company.

HSBC Sri Lanka has effective processes in place to ensure compliance with applicable laws and regulations pertaining to the banking industry in Sri Lanka, including The Banking Act, Prevention of Money Laundering Act No 5 of 2006 (PMLA) and Amendment No 40 of 2011, Financial Transactions Reporting Act No 6 of 2006 and related Acts, Companies Act No. 7 of 2007 and the Central Bank of Sri Lanka directions and guidelines. Additionally we are also bound to comply with the applicable directions of the Company. Also the Banking Act Direction No. 11 of 2007 and its amendments on Corporate Governance for Licensed Commercial Banks in Sri Lanka, issued by the Monetary Board of the Central Bank of Sri Lanka under section 46 (1) of the Banking Act No. 30 of 1988 provides that the mandatory requirements set out in section 3 of the said Direction should be complied with by Licensed Commercial Banks. All branches of foreign banks are requested to adhere to sections 3 (8) and 3 (9). HSBC Sri Lanka complies with the said Direction on Corporate Governance.

The Group has adopted a risk management and internal control structure, referred to as the Three Lines of Defence, to ensure it achieves its commercial aims while meeting regulatory and legal requirements and its responsibilities to shareholders, customers and staff.

**The First Line of Defence** consists of 'Risk Owners' and 'Control Owners'. Our Global Businesses are the Risk Owners. They are accountable and responsible for managing risk in their day-to-day activities through processes and controls. Control Owners exist in Global Businesses, Global Functions and Operational areas. They are required to monitor and provide an opinion on the effectiveness of the controls relied upon by the Risk Owners to manage their risks. The First Line of Defence ensure all key risks are identified, mitigated and monitored by an appropriate control environment.

**The Second Line of Defence** consists of Risk Stewards and their teams. It is made up in part (but not exclusively) by leaders within Global Risk and other Global Functions. They set policy, give advice and provide independent challenge. In doing this, they oversee and assess the risk management activities carried out by the First Line. They support the Risk Owners with setting their risk appetite within the Group's overall risk appetite. It provides assurance over the effectiveness of the risk and control activities conducted by the First Line of Defence.

**The Third Line of Defence**, Global Audit, independently assures our risk management, governance and internal controls to make sure they are effective and fit for purpose. They are responsible for providing independent assurance to management and the Board over the design and operation of HSBC's risk management, governance and internal control processes.

The existing Compliance team has two distinct sub-functions: Financial Crime Compliance (FCC) and Regulatory Compliance (RC).

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FCC is focused on:

- Anti-Money Laundering (AML), Counter Terrorist Financing & Proliferation Finance
- Sanctions
- Anti-Bribery and Corruption (AB&C)

RC is focused on:

- Conduct of Business (Customer, Counterparties and Clients as well as Products and Services)
- Market Conduct
- General regulatory compliance management including stakeholder support

There is a Financial Crime Compliance Programme now underway to manage change and this is part of Global Standards. There are three key components in this Programme and they are:

- Aligning current activities, such as Know Your Customer and customer screening, and building these into a new and far more integrated framework to conduct Customer Due Diligence. This will enable HSBC to manage financial crime risk more effectively across the complete customer life cycle.
- Building stronger controls to improve the way Financial Crime Compliance risks are managed. Improved controls will help HSBC to measure how effective they are at managing financial crime in any given business or country – and help them to spot gaps as well as trends, so they can take action.
- The way customers, both at a personal and business level, do their banking today has changed in recent years. As part of this change, HSBC has made a significant investment in new technology to make sure we're gathering and analysing financial intelligence in a smart way, so that we can identify suspicious transactions, activity or connections.

The Regulatory Compliance team is responsible for setting the policies and standards which cover HSBC's regulatory requirements, and supports the management of conduct and reputational risk issues. The team works closely with the Global Businesses and Functions while maintaining an independent and challenging mind set. This is a critical part of being the second line of defence.

Given the dynamic and evolving regulatory environment HSBC is operating in today, the Regulatory Compliance team is relied upon to grasp the regulatory change agenda and ensure the business areas understand the implications and are prepared for change.

The Regulatory Compliance team also monitors how the Global Businesses and Functions manage their responsibilities with regard to complying with the required regulations, and will support the resolution of compliance deficiencies.

At the operational level, the Compliance Officer, in charge of both FCC and RC, will:

- Compile and maintain Compliance Risk Assessments. The Compliance Risk Assessment identifies and assess all risks for which the Compliance function has oversight responsibilities in order that suitable mitigating action can be planned and taken. The assessment and risk rating is documented, and reviewed to ensure the list of risks identified remains complete and the rating applied to each is appropriate.

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- Devise annual Compliance Plans to record risk-based activity planned for the coming year and the resources necessary to deliver it.
- In accordance with the annual Compliance Plan, undertake regular monitoring and ad-hoc reviews as may be necessary to verify that controls remain robust and understanding of / adherence to procedures is maintained.
- Report compliance control failures, or incidents which may indicate a need to review Compliance Risk Assessments or mitigating procedures. As well as facilitating reporting within the business e.g. to local audit committees and/or regulators
- Prepare Compliance Certificates every six months, countersigned by business Management, certifying that all relevant matters have been reported within Compliance as appropriate, and that where necessary corrective action has been taken to address any issues arising.

In addition to RC and FCC, a number of teams are formed as RC/FCC shared services to support the two functions, for example, Regulatory Affairs & Policy (RAP) and Compliance Monitoring & Testing (CMAT).

RAP is responsible for all Regulatory Engagements, Regulatory Development and Policy Governance in Sri Lanka and Maldives.

CMAT is responsible for carrying out monitoring activities to provide a reasonable assurance to the business that their 1st line of defense is sound and sufficient as far as FCC and RC are concerned. This is being established through two main activities:

- By testing the adequacy of existing FCC / RC controls in the 1st line
- By identifying any gaps in the control environment for FCC / RC compliance and advise the business to develop or maintain controls to mitigate any potential risks.

Jayant Rikhye  
(Signed) Head of International Asia Pacific  
Head of Strategy and Planning Asia Pacific

Patrick J Gallagher  
(Signed) Chief Executive Officer Sri Lanka and  
Maldives

Date: 21 MAY 2015