



**November 2010**

**To: Members of the Hong Kong Institute of CPAs  
All other interested parties**

**INVITATION TO COMMENT ON EXPOSURE DRAFT ON  
REVISED PRACTICE NOTE 820 THE AUDIT OF LICENSED  
CORPORATIONS AND ASSOCIATED ENTITIES OF  
INTERMEDIARIES**

***Comments to be received by 30 November 2010***

The Hong Kong Institute of Certified Public Accountants' (Institute) Auditing and Assurance Standards Committee (AASC) is seeking comments on the Exposure Draft which has been posted on the Institute's website at:

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/auditing-assurance/exposure-drafts/>.

The AASC has embarked on a project, with the assistance of the Institute's Securities and Investment Funds Panel, to align the extant Practice Notes (PN) with the development of the auditing and assurance pronouncements recently issued. As part of the project, the proposed revised PN 820 has been updated to align with the clarified Hong Kong Standards on Auditing (HKSAs) and best practices in the industry.

The proposed revised PN has been prepared in consultation with the Securities and Futures Commission (SFC) and the key revisions are:

- Part II has been revised to reflect the clarified HKSAs;
- Part IV has been revised to provide guidance in respect of cessation of activities by a licensed corporation;
- Example 1 of Appendix 1 has been revised to align with clarified HKSAs; and
- Appendix 2 has been revised to reflect updated guidance on client assets.

The proposed revised PN also discusses various obligations imposed on auditors by the SFO which ultimately should be determined by the court. Members may wish to seek legal advice as to the interpretations of the relevant legislation when making their comments.

--- In order for readers to easily identify all the changes, we have attached a marked up version and a clean version of the Exposure Draft.

Comments on the proposed changes should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the Exposure Draft to be considered, comments on the exposure draft are requested by the due date shown above.

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

November 2010  
Exposure Draft

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Response Due Date  
30 November 2010

*ED of Proposed Revised PN 820*

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## **The Audit of Licensed Corporations and Associated Entities of Intermediaries**



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

## CONTENTS

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ED of Proposed Revised Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries"

This Exposure Draft may be filed in the "Exposure Drafts, Invitations to Comment" section of Volume III of the Institute Members' Handbook.

The Exposure Draft can also be found on the Institute's website at:

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/auditing-assurance/exposure-drafts/>.



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

Effective upon issue

*Practice Note 820*

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# **The Audit of Licensed Corporations and Associated Entities of Intermediaries**



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

**PRACTICE NOTE  
820  
THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES**

*(Issued February 2004; revised September 2004 (name change), ~~and~~ revised March 2008 and revised  
[ ])*

<i>Contents</i>	<i>Paragraphs</i>
<b><u>PART I – GENERAL</u></b>	
Introduction	1 - 7
Definitions	8
Legislation and regulatory requirements	9 - 27
<b><u>PART II - THE AUDIT OF FINANCIAL STATEMENTS</u></b>	
Introduction	28
HKSA's	29 - <del>70</del> 69
<b><u>PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES</u></b>	
Introduction	<del>71</del> 9
Management's responsibilities	<del>72</del> 4 - <del>75</del> 4
Auditor's responsibilities	<del>76</del> 5 - <del>79</del> 8
General guidance for fulfilling auditor's responsibilities	<del>80</del> 79 - <del>83</del> 2
Auditor's reporting requirements	<del>84</del> 3 - <del>89</del> 8
Guidance on the reporting requirements of the Compliance report	<del>89</del> 0 - <del>114</del> 3
<b><u>PART IV - OTHER REPORTING CONSIDERATIONS</u></b>	
Audit Questionnaire	<del>115</del> 4 - <del>117</del> 6
Account Disclosure Document	<del>118</del> 7
<b><u>Cessation of Activities</u></b>	<b><u>119 - 120</u></b>
<b><u>PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION</u></b>	
Introduction	<del>121</del> 18 - <del>125</del> 2
The auditor to lodge report with the SFC in certain cases	<del>126</del> 3 - <del>135</del> 2
Other communications by the auditor	<del>136</del> 3 - <del>158</del> 5

**The auditor's duty of secrecy** **1596 - 1644**

**Communications by the SFC to the auditor under  
section 378(3)(h) of the SFO** **1652 – 1674**

**APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS**

**APPENDIX 2 - CLIENT ASSETS**

**PRACTICE NOTE**  
**820**  
**THE AUDIT OF LICENSED CORPORATIONS AND**  
**ASSOCIATED ENTITIES OF INTERMEDIARIES**

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

*Practice Notes are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in ~~HKSA and HKSAEs~~ Hong Kong Engagement Standards, even though they may be developed without the full process of consultation and exposure used for ~~HKSA and HKSAEs~~. This Practice Note provides guidance to assist the auditor to fulfill the objectives of the engagement. The auditor should be prepared to explain departures when called upon to do so.*

**PART I - GENERAL**

**Introduction**

1. The purpose of this Practice Note is to assist the auditor to develop an approach to the audit of the financial statements of licensed corporations and associated entities of intermediaries. This is dealt with in Part II.
2. This Practice Note also provides guidance on the auditor's other reporting responsibilities under the Securities and Futures Ordinance (SFO) which are set out in the Securities and Futures (Accounts and Audit) Rules. This is dealt with in Part III.
3. Guidance on the completion of the Securities and Futures Commission's (SFC) Audit Questionnaire by the auditor is set out in Part IV.
4. The auditor is entitled under the SFO to report directly to the SFC in exceptional circumstances and, in some cases, has a duty to do so. Guidance on such ad hoc reporting is set out in Part V.
5. This Practice Note has been prepared in consultation with the SFC.
6. This Practice Note is based on the SFO in effect as at 1 April 2003, and the subsidiary legislation, codes and guidelines issued by the SFC up to 1 August 2007. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this Practice Note should be used in conjunction with the legislation.
7. It should be borne in mind that certain expressions used in the SFO may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this Practice Note, the auditor will wish to seek legal advice.



## Definitions

8. The definitions used in this Practice Note are:

a. *Associated entity*

A company that is in a controlling entity relationship with an intermediary and receives or holds in Hong Kong client assets of the intermediary.

b. *Client assets*

As defined in section 1 in Schedule 1 of the SFO.

c. *Client asset rules*

Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules.

d. *Codes and guidelines*

Codes and guidelines issued by the SFC under the SFO.

e. *FRR*

Securities and Futures (Financial Resources) Rules.

f. *Intermediary*

A licensed corporation or a registered institution.

g. *Internal Control Guidelines*

"Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission" issued by the SFC.

h. *Licensed corporation*

A corporation which is granted a licence by the SFC under Part V of the SFO for a regulated activity.

i. *Liquid assets*

Such assets as are prescribed in Division 3 of Part 4 of the FRR.

j. *Liquid capital*

The amount by which liquid assets exceeds ranking liabilities.

k. *Ranking liabilities*

The amounts required under Division 4 of Part 4 of the FRR.

l. *Registered institution*

An authorized financial institution registered under Part V of the SFO.

m. *Regulated activities*

Dealing in securities, dealing in futures contracts, leveraged foreign exchange trading, advising on securities, advising on futures contracts, advising on corporate finance, providing automated trading services, securities margin financing and asset management.

n. *Regulated entity*

A licensed corporation or an associated entity of an intermediary.

o. *Segregated account*

A segregated account established and maintained under section 4(1) and (2) of the Securities and Futures (Client Money) Rules or under section 5(1) and (2) of the Securities and Futures (Client Securities) Rules.

p. *SFC*

Securities and Futures Commission.

q. *SFO*

Securities and Futures Ordinance.

r. *Suggested Control Techniques*

"Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.

s. *Systems of control*

The internal controls over trading, accounting, settlement and stock holding systems that a licensed corporation or an associated entity has implemented to ensure its compliance with the SFO and any rules made under the SFO.

## Legislation and regulatory requirements

### The SFO

9. Under the licensing and registration regime of the SFO, any business entity which carries on or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by or registered with the SFC. It is a serious offence to act as an intermediary in Hong Kong without the appropriate licence or registration.
10. The SFC administers the regulation of the regulated activities and assumes the duties of front-line regulator of licensed corporations. It also applies certain requirements to associated entities of intermediaries in relation to their receipt and holding of client assets. The SFC is also responsible for all investigations and disciplinary matters under the SFO, subsidiary legislation, codes and guidelines.
11. Regulated entities must observe at all times all the provisions of the SFO, subsidiary legislation, codes and guidelines. In association with these requirements, regulated entities must file audited annual financial statements within four months of the financial year end to the SFC.
12. The SFO is designed to protect investors and, therefore, is concerned with ensuring that regulated activities in Hong Kong are conducted in accordance with the relevant regulations and rules by persons who are fit and proper and are licensed or registered to conduct such business.

13. The regulatory powers of the SFC are primarily vested in the SFO.
14. Section 5 of the SFO details the functions of the SFC. The functions pertinent to this Practice Note are as follows:
- a. to take steps to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - b. to supervise, monitor and regulate activities carried on by regulated entities;
  - c. to promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on regulated activities;
  - d. to promote and develop an appropriate degree of self-regulation;
  - e. to take steps it considers appropriate to ensure relevant provisions are complied with;
  - f. to secure an appropriate degree of protection for members of the investing public investing in or holding financial products;
  - g. to promote, encourage and enforce the adoption of appropriate internal controls and risk management systems; and
  - h. to suppress illegal, dishonourable and improper practices in the industry.

*Regulated activities*

15. The SFO covers nine types of regulated activities:

Type 1: dealing in securities;

Type 2: dealing in futures contracts;

Type 3: leveraged foreign exchange trading;

Type 4: advising on securities;

Type 5: advising on futures contracts;

Type 6: advising on corporate finance;

Type 7: providing automated trading services;

Type 8: securities margin financing; and

Type 9: asset management.

*Auditor's statutory rights and duties*

16. Guidance on the auditor's statutory rights and duties under the SFO is given in Parts III and V below.

**Regulatory requirements**

17. The SFO provides a framework for the regulation of regulated entities in Hong Kong and the detailed requirements are set out in subsidiary legislation, codes or guidelines issued by the SFC. Each regulated entity is bound by all these requirements, where applicable, to remain fit and proper. The main provisions of the SFO, subsidiary legislation, codes or guidelines are set out in the following paragraphs but they are not a substitute for the legislation and rules themselves. In addition, the SFC has posted a series of "Frequently Asked Questions" on its website which provide a useful source of reference on how to interpret specific circumstances which may arise.

*Licensing and registration*

18. Persons carrying on business in a regulated activity in Hong Kong are required to have successfully applied for a licence, or a registration in the case of an authorized financial institution. In addition, they must remain fit and proper at all times.

*Business conduct*

19. This is the ongoing requirement expected of regulated entities in conducting their business and is designed to ensure that adequate standards are maintained in dealings with clients.
20. The requirements for business conduct are set out either in subsidiary legislation or in non-statutory codes of conduct. Breach of legislation is subject to criminal sanctions and breach of any codes of conduct may be taken into account in determining fitness and properness. The auditor has no requirement to express an opinion on the business conduct of a regulated entity but should be aware of the requirements.
21. The nine basic principles for business conduct cover the following areas:
- a. honesty and fairness;
  - b. diligence;
  - c. capabilities;
  - d. information about clients;
  - e. information for clients;
  - f. conflicts of interests;
  - g. compliance;
  - h. client assets; and
  - i. responsibility of senior management.

*Client assets*

22. The client asset rules apply to regulated entities that control or are otherwise responsible for client assets and they cover the proper protection of these assets. There are two sets of rules:
- a. one dealing with client securities; and
  - b. the other dealing with client money (not applicable to an associated entity of a registered institution or an associated entity of a licensed corporation where the associated entity is an authorized financial institution).
23. The Securities and Futures (Client Securities) Rules require client securities and securities collateral received or held in Hong Kong to be treated by regulated entities in a prescribed manner, such as depositing the securities in the safe custody of a segregated account. There are no prescribed rules for client securities received or held overseas.
24. The Securities and Futures (Client Money) Rules require segregation of client money received or held in Hong Kong by licensed corporations and their associated entities (unless they are authorized financial institutions) within the specified time limit. There are no prescribed rules for client money received or held overseas.

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

*Record keeping*

25. The Securities and Futures (Keeping of Records) Rules are rules for the keeping of accounts and records by regulated entities. Such records are required to contain sufficient details to explain business activities and operations and account for their client assets, and to be retained for a specified period of time.

*Financial resources requirements*

26. The FRR are made to ensure that licensed corporations are financially sound and have the resources to provide adequate services to investors.
27. Subject to exceptions, licensed corporations are subject to the paid-up capital and liquid capital requirements. The requirements are different for different regulated activities. However, where a corporation is licensed for more than one regulated activity, the highest of the paid-up share capital and liquid capital requirements which are applicable to the different regulated activities will apply.

## PART II - THE AUDIT OF FINANCIAL STATEMENTS

### Introduction

28. Hong Kong Standards on Auditing (HKSA) apply to the audit of the financial statements of any entity, irrespective of the size of the entity, its legal form, or the nature of its activities. The commentary which follows identifies the special considerations arising from the application of certain individual HKSA to the audit of the financial statements of regulated entities, and suggests ways in which these can be addressed. Where no special considerations arise in relation to a particular HKSA, no material is included. For the specific requirements of a HKSA, auditor would refer to the HKSA concerned.

### HKSA 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS

#### Background note

**The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The auditor and the client should agree on the terms of the engagement.** (HKSA 210 paragraph 29)

29. In addition to those principal contents set out in HKSA 210, the auditor's engagement letter would also cover reporting requirements under the Securities and Futures (Accounts and Audit) Rules and in particular, the auditor's rights and duties to report directly to the SFC. The engagement letter makes it clear that the statutory duty to report places an obligation on the auditor to report matters if found and does not involve undertaking additional work to identify them. It also clarifies that the auditor may sometimes consider it necessary to report directly to the SFC without the client's prior knowledge or consent.

### HKSA 240: THE AUDITOR'S RESPONSIBILITIES RELATING TO CONSIDER FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

#### Background note

**In accordance with HKSA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.** (HKSA 240 paragraph 325)

30. In addition to the conditions or events specified in HKSA 240 as increasing the risk of fraud, the following factors may be especially relevant for regulated entities (this list is not exhaustive):
- backlogs in key reconciliations, particularly those with brokers and exchanges and for bank accounts and safe custody accounts - both the regulated entity's own and those relating to its clients;
  - inadequate segregation of duties between the front, middle and back office staff (i.e. "incompatible functions");
  - complex products and transactions inadequately understood by management;
  - inadequate definition of management responsibilities and supervision of staff;
  - elements of the remuneration package (particularly bonuses) for certain staff which are highly geared in relation to reported profits or revenues;

- f. existence of hold mail arrangements, operation of discretionary accounts, and issuance and acceptance of third party or cash cheques;
- g. volatility in the market place;
- h. no established compliance culture or inadequate internal controls; and
- i. risk of management override of controls.

Additional factors relevant for regulated entities can be found in the SFC's website which contain press releases and circulars providing examples of malpractices and advisory circulars of compliance areas.

31. Regulated entities are specifically required by the SFC to have adequate systems of internal control over client assets, which include appropriate systems to minimize the risk of losses to the business from irregularities, fraud or error. The auditor needs to bear in mind their responsibilities to report to the SFC in accordance with guidance set out in Part V below.

## HKSA 250: CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

### Background note

**The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. (HKSA 250 paragraph 213)**

32. The auditor needs to recognize particularly that some laws and regulations are central to the regulated entity's ability to conduct its business as compliance is a prerequisite of obtaining a licence to operate. Non-compliance may reasonably be expected to result in the regulated entity ceasing operations, or call into question the regulated entity's status as a going concern.
33. The auditor of regulated entities will normally:
- a. discuss with the regulated entity's general counsel, compliance officer, internal auditor and other personnel responsible for compliance, and review any work on compliance matters carried out by them;
  - b. read the SFC's press releases and public register of licensed persons on its website for any disciplinary actions or licensing conditions imposed on the licensed corporation, its responsible officer or licensed representative;
  - c. review correspondence between the regulated entity and the SFC; and
  - d. assess the actual or contingent consequences arising from non-compliance and consider the impact on the financial statements.
34. If the auditor becomes aware of correspondence between the regulated entity and the SFC which are subject to the secrecy provisions of section 378 of the SFO, the auditor should request the regulated entity to seek the SFC's consent to disclosing the correspondence to the auditor. Paragraphs 165 to 167 provide additional information on the circumstances that the SFC may communicate to the auditor matters pertinent to a regulated entity for the purpose of enabling or assisting the SFC to perform its functions under any of the relevant provisions and paragraph 70b provides suggestions for additional representation to be obtained from management.

## Money Laundering

- ~~34~~35. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which regulated entities operate. By the nature of their business, regulated entities may be ready targets of those engaged in money laundering activities.
365. The primary bodies of law in Hong Kong concerned with the subject of money laundering are the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance. Details on the matters are set out in the related guidance notes and circulars issued by the SFC. The HKICPA has issued in July 2006 a Legal Bulletin on "Requirements on Anti-money Laundering, Anti-terrorist Financing and Related matters".
376. The SFC expects regulated entities to establish policies and controls to combat money laundering and terrorist financing which cover the following areas:
- a. the establishment and maintenance of policies, procedures and controls to deter and to recognize suspicious transactions;
  - b. the establishment of a procedure to report suspicious transactions;
  - c. evidence of client identification;
  - d. retention of client identification and transaction records for use as evidence in future investigations; and
  - e. education and training of staff.

## Codes and guidelines issued by the SFC

387. The auditor has no direct reporting responsibility in respect of the codes and guidelines issued by the SFC. Nevertheless, breaches of such codes and guidelines may:
- a. give rise to claims by investors against the regulated entity; and
  - b. cause the regulated entity to have its business restricted or, in extreme cases, have its licence revoked so threatening its viability as a going concern.
398. The auditor will also be aware that breaches of the codes and guidelines could have consequences for other matters which are the subject of the auditor's reporting responsibilities to the SFC for example, financial resources, accounting records and the handling of client assets.
- ~~40~~39. The auditor would ensure that members of the audit team have a general understanding of the applicable codes and guidelines, sufficient to enable them to be alert to possible non-compliances which come to their attention.
410. As part of the normal procedures undertaken for the purposes of the audit of the financial statements and reporting under the Securities and Futures (Accounts and Audit) Rules, the auditor would gain an understanding of the regulated entity's operations, including the nature of the business carried out. They would also obtain an understanding of the control environment that exists, including the regulated entity's higher level procedures for complying with the applicable codes and guidelines.



424. Such an understanding will provide an indication of the extent to which the general atmosphere and controls in the regulated entities are conducive to compliance, for example through consideration of:
- the adequacy of procedures and training to inform staff of the requirements of the applicable codes and guidelines to ensure that they meet those requirements;
  - adequacy of authority and supervision;
  - the review of compliance by senior management;
  - procedures to ensure that possible non-compliances are investigated by an appropriate person and are brought to the attention of senior management; and
  - the authority of, and resources available to, the compliance officer, internal auditor and those in charge of compliance functions.
432. The auditor needs to be alert to any indication that a regulated entity is conducting business outside the scope of its licence as this may amount to an offence under the SFO.
443. Where an apparent non-compliance of the codes and guidelines comes to the auditor's attention, it needs to ensure that the implications for its reporting responsibilities are correctly identified.
454. The auditor would enquire of management and staff whether any non-compliances have occurred and obtain appropriate representations from management, preferably in writing, addressing any possible non-compliances which have come to their attention.
465. The auditor would also note that the Codes and Guidelines issued by the SFC are not exhaustive in nature and auditor would always exercise professional judgment in determining the adequacy of controls and certain behaviours/conduct.

## **HKSA 260: COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE**

### **HKSA 265: COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT**

#### **Background note**

~~*The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. (HKSA 260 paragraph 2)*~~

**The auditor shall communicate the following matters with those charged with governance:**

- The auditor's responsibilities in relation to the financial statement audit (HKSA 260 paragraph 14);**
- Planned scope and timing of the audit (HKSA 260 paragraph 15);**
- Significant findings from the audit (HKSA 260 paragraph 16); and**
- In the case of listed entities, auditor independence (HKSA 260 paragraph 17).**

**The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (HKSA 265 paragraph 9)**

476. The SFC may request copies of the auditor's management letters from regulated entities. Against this background, the auditor may consider it prudent to include in its report to directors or management, as a matter of course, a statement that:

- a. the management letter has been prepared for the sole use of the regulated entities;
- b. it must not be disclosed to a third party (except to the SFC), or quoted or referred to, without the written consent of the auditor; and
- c. no responsibility is assumed by the auditor to any other person.

#### **Breach of laws and rules issued by the SFC**

487. Unless there are reasons for supposing a report would be made directly to the SFC (see Part V below), the auditor would discuss promptly with appropriate management of the regulated entity (including the compliance officer) apparent breaches of the law, codes and guidelines, or instances where a regulated entity may be carrying on activities outside the scope of its authorization, which come to their attention in the course of the audit. This will both enable the auditor to determine the impact of the matter on its reporting obligations, and permit appropriate corrective action to be taken by management.
498. Breaches or possible breaches of the law, codes and guidelines which come to the auditor's attention and which neither require the auditor to make a report to the SFC under the statutory duty provisions of the SFO, nor require its auditor's report to be qualified, will be considered for inclusion in the auditor's management letter.

### **HKSA 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS**

#### **HKSA 315: IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**

##### **Background note**

*The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. The auditor should plan the audit so that the engagement will be performed in an effective manner. (HKSA 300 paragraph 27)*

*The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures. (HKSA 315 paragraph 25)*

*Risk assessment procedures are defined as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. (HKSA 315 paragraph 4.(d))*

4950. Regulated entities can be complex and the auditor would seek to understand the business and the regulatory regime in which they operate. The auditor would ensure that the audit engagement is performed/overseen by staff with sufficient knowledge about the licensed corporation's operations, market practices, the products handled by the licensed corporation and the SFC regulations for regulated activities carried out by the licensed corporation. A fundamental principle embodied in the HKICPA Code of Ethics for Professional Accountants is that the auditor does not accept or perform work which it is not competent to undertake. The auditor may also consider the use of technical specialists, for example where the business is trading in complex products or is heavily reliant on e-commerce. Generally, there is a close relationship between planning and understanding the entity and an understanding of the high level control environment.

510. To avoid potential duplication of audit effort, the audit approach to a regulated entity normally addresses the audit of the financial statements and the work required for reporting under the Securities and Futures (Accounts and Audit) Rules together. The auditor plans so as to ensure that its audit work on the financial statements and the regulatory reporting is completed within timescales imposed by the SFC. The audit plan for a regulated entity typically explains the legal and regulatory background and, in order to reduce audit risk, discusses those areas where the auditor's responsibilities are different from those for other types of entity.

#### **Direct communication from the SFC**

524. As explained in paragraph 462-165 below, the SFC is able to disclose information directly to the auditor. Where such a matter has been brought to the attention of the auditor, it considers the implications for its work and may amend its approach accordingly. However, the fact that it may have been informed of such a matter by the SFC does not, of itself, require the auditor to change the scope of its work, nor does it require the auditor actively to search for evidence in relation to the matter communicated by the SFC.
532. The auditor has no obligation to seek out breaches of the law, codes and guidelines. However, the auditor would include procedures within their planning process to ensure that members of the audit team are able to recognize reportable matters which are likely to be encountered in their audit work and that such matters are reported to the audit partner without delay.

#### **Internal controls and risk assessment**

543. There is a wide variation between different regulated entities in terms of size, activity and organization, so that there can be no standard approach to internal controls and risk. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. In addition to the factors set out in paragraphs A17 to A41 and ~~Appendices 1 and 2~~ of HKSA 315, the following factors would be considered by the auditor in assessing whether there may be an increased level of inherent risk of material misstatement:
- a. the nature and status of the regulated entities and any changes in their status which may affect the application of protection of clients' assets requirements;
  - b. a change in the market environment (for example, high volatility);
  - c. the introduction of new clients or products or marketing and distribution methods (for example e-commerce);
  - d. claims made in promotional literature (for example in relation to risks and performance);
  - e. the risk profile of business undertaken;
  - f. client profile (retail vs. institutional);
  - g. existence of claims and complaints by clients;
  - h. the complexity of products;
  - i. the consistency of products, methods and operations in different departments or locations;
  - j. the legal and operational structure of the regulated entities;
  - k. where a group structure exists, the financial and managerial support provided to and by other group companies;
  - l. the number of branches or sales offices (see paragraph 56-57 below);
  - m. the use of licensed representatives;

- n. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
  - o. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;
  - p. the recruitment, competence, training and supervision of personnel; and
  - q. the integrity, competence and experience of management.
554. Regulated entities vary greatly in the complexity of their operations and hence in the reliance which the auditor places on their detailed internal controls. These are particularly important in cases where the accounting system is at risk of failing to capture transactions which do not involve the immediate movement of funds - such as trading in certain derivative instruments or underwriting. A sound understanding of the process is required in order to guard against the risk of unrecorded or mis-recorded transactions. These may or may not be unauthorized but will also expose the regulated entity to possible loss, through failure to appreciate the risks which are actually being run.
565. Client assets is one area where detailed internal controls are particularly relevant. ~~Notwithstanding its off-balance sheet nature, e~~ Client assets are an important and relevant factor to audit planning and any material deficiency in the adequacy of internal controls over client assets will need to be reported in the Compliance Report (see paragraphs 1076 to 1109). Any shortfall in client assets, whether due to misappropriation or otherwise, may have significant implications on the licensed corporation's compliance with the client asset rules and the adequacy of its internal controls. Furthermore, such shortfall could also impact on the financial position of the licensed corporation. Such implications and impact could affect the opinions to be given by the auditor in its audit report and compliance report and trigger the auditor's obligation to report to the SFC under section 157 of the SFO. If the auditor considers that the licensed corporation's system of control over client assets are inadequate or decides that no reliance would be placed on the licensed corporation's systems, the auditor would use its professional judgment to consider the use of fund tracing procedures or external circularisation as a substantive procedure to obtain evidence on some of the control objectives, e.g. paragraphs 45 and 47 of Appendix 2. Fund tracing means obtaining copies of sampled outward cheques issued by the licensed corporation from the bank or copies of cheques deposited into the bank account of the licensed corporation and verifying the identity of the payee or drawer against the licensed corporation's accounting records.
576. Some regulated entities operate a network of branches. In such instances, the auditor determines the degree of head office control over the business and accounting functions at the branch office and the scope and effectiveness of the regulated entity's inspection and/or internal audit visits. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the regulated entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to audit planning.

587. The auditor would consider how a computer information system (CIS) environment affects the audit. Computer information system (CIS) is integral to the business of a regulated entity due to the high volume of transactions and the linkages to various third party systems. Many regulated entities also use their CIS to prepare regulatory reports to the SFC. It is therefore common for the auditor to require a detailed knowledge of the regulated entity's CIS.
598. As new CIS technologies emerge, they are frequently employed by regulated entities to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of CIS and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

## **HKSA 320: AUDIT MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

### **Background note**

~~*When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. The auditor should consider materiality and its relationship with audit risk when conducting an audit.*~~ (HKSA 320 paragraph 210)

~~*The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.*~~ (HKSA 320 paragraph 11)

~~*For purposes of the HKSAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.*~~ (HKSA 320 paragraph 9)

6059. The assessments of materiality and performance materiality for the financial statements of a Licensed Corporation will require an auditor to make the same professional judgment decisions as on any audit with reference to the Standard. However the auditor would remember that in respect of the Compliance Report there is no materiality concept outlined in the Securities and Futures (Accounts and Audit) Rules and therefore if the auditor becomes aware of any breach in the relevant Rules then that breach needs to be reported in the Compliance Report. The Audit Questionnaire that the auditor is asked to complete for submission to the SFC does however refer to whether the auditor has found any material breaches between the FRR submitted and the financial statements and therefore it is possible to have a reconciliation reported in the Compliance Report in respect of immaterial discrepancies between the submitted FRR and the financial statements but not to report this matter in the Audit Questionnaire if it is deemed to be immaterial.

## **HKSA 402: AUDIT CONSIDERATIONS RELATING TO AN ENTITYIES USING A SERVICE ORGANIZATIONS**

### **Background note**

~~*The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. The auditor should consider how an entity's use of a service organization affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.*~~ (HKSA 402 paragraph 211)

610. Some regulated entities outsource a variety of activities. Specific examples include:
- a. safe custody of client assets by a custodian;
  - b. settlement or clearing of trades (this may or may not include the third party taking on the settlement risk, maintaining accounting records, reconciling client assets, sending client statements directly);
  - c. maintenance of accounting records;
  - d. product administration (such as unit trusts or savings schemes);
  - e. investment management; and
  - f. valuation of investments.
624. A regulated entity would ensure compliance with the law, codes and guidelines whether or not activities are outsourced. In addition, a regulated entity using a service organization would comply with the following requirements in respect of the outsourced activities:
- a. ongoing assessment and monitoring of the competence and independence of the third party including reviewing of reports issued in accordance with Practice Note 860.2 "Reports on internal controls of investment custodians made available to third parties" or Hong Kong Standard on Assurance Engagements 3402 "Assurance Reports on Controls at a Service Organization" or other relevant service provider reports;
  - b. responsibility for keeping records; and
  - c. responsibility for acts or omissions by the third party.

## HKSA 505: EXTERNAL CONFIRMATIONS

### Background note

**The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level. (HKSA 505 paragraph 216)**

632. External confirmation of client account balances can provide strong evidence regarding the existence of the account at a certain date. It can also provide strong audit evidence regarding the operation of cut-off procedures.
643. For efficiency purpose, the auditor may circularize external confirmations of client account balances together with client assets held for custody so as to obtain audit evidence to support the financial statement assertions and regulatory reporting items at the same time. Further details on circularisation are set out in paragraph 27 of Appendix 2 to this Practice Note.
654. In determining the auditor's assessment of risk, consideration as to whether or not to perform external circularisation would also be linked to the fraud assessment (HKSA 240) and the assessment of the quality of internal controls, particularly over client assets (HKSA 315). The higher the auditor's assessment of risk, the more important it is for the auditor to seek reliable and relevant audit evidence from substantive procedures. For example, if the auditor considers that the licensed corporation has inadequate systems of control over client assets, or the auditor decides not to rely on the licensed corporation's internal control systems, then external

confirmations of client account balances and client assets held by the licensed corporation would be a strong substantive audit procedure. In addition, the auditor may find it effective to supplement such external confirmations with a questionnaire to obtain corroborative information on the licensed corporation's compliance with aspects of the legislation and rules that the auditor also has responsibility to verify e.g. standing authorities.

## **HKSA 560 (REVISED): SUBSEQUENT EVENTS**

### **Background note**

**Subsequent events are defined as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. (HKSA 560 paragraph 5(e))**

**The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. ~~The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. (HKSA 560 (Revised) paragraph 26)~~**

**The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:**

- a. Discuss the matter with management and, where appropriate, those charged with governance.**
- b. Determine whether the financial statements need amendment and, if so,**
- c. Inquire how management intends to address the matter in the financial statements.**

**(HKSA 560 paragraph 10)**

665. In addition to the specific procedures to identify subsequent events which may require amendment to, or disclosure in the financial statements outlined in paragraph 76 of HKSA 560 (Revised), for the regulated entity, the auditor would review correspondence with the SFC since the period end and make enquiries of management to determine whether any breaches of the law, codes and guidelines or other regulatory concerns have come to light since the period end.

## **HKSA 570: GOING CONCERN**

### **Background note**

**The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. ~~When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. (HKSA 570 paragraph 211)~~**

676. In reviewing going concern, the auditor of a regulated entity would consider the following areas in addition to those set out in paragraph 8-A2 of HKSA 570, since the possible regulatory action of the SFC on the regulated entity is particularly relevant to the going concern assumption:
- a. regulatory censure or fines;
  - b. regulatory capital shortages;
  - c. visits from the SFC;
  - d. reputation and other indicators (including client complaints);
  - e. general non-compliance with the law, codes and guidelines; and
  - f. unusual movements in the financial market.
687. If the auditor has any doubts as to the ability of a regulated entity to continue as a going concern, it may be required to make a report to the SFC under their statutory duties on which guidance is set out in Part V below.
69. If the auditor is performing a cessation audit as discussed in paragraphs 119 and 120, the auditor may wish to consider whether the financial statements of that entity should be prepared on a going concern or a break-up basis.

## HKSA 580: MANAGEMENT WRITTEN REPRESENTATIONS

### Background note

**The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. The auditor should obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements.** (HKSA 580 paragraph 39)

70698. In addition to the examples of representations given in HKAS 580, the auditor of a regulated entity would also consider obtaining additional confirmations. The letter could cover inter alia the following representations:
- a. acknowledging management's responsibility for establishing and maintaining accounting records and systems of control in accordance with the law, codes and guidelines;
  - b. confirming that management has made available to the auditor all correspondence and notes of meetings with the SFC (except for correspondence subject to section 378 of the SFO where no consent has been given by the SFC for the licensed corporation to disclose such correspondence to the auditor, if applicable) during and related to the relevant reporting period and up to the date of the auditor's report;
  - c. that all complaints have been drawn to the attention of the auditor;
  - d. where applicable, representation that no client money or client securities were administered or held by the regulated entity; and
  - e. that the requirements under the Securities and Futures (Keeping of Records) Rules, the client asset rules and the FRR have been complied with.



## **~~HKSA 720: OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS~~**

### **Background note**

***~~The auditor should read the other information to identify any material inconsistencies with the audited financial statements. (HKSA 720 paragraph 2)~~***

- ~~69. The SFC has issued an Account Disclosure Document for Licensed Corporation setting out additional financial information to be disclosed. The auditor would comply with the requirements in HKSA 720 in respect of the additional financial information which would be disclosed as part of the accompanying information to the financial statements. The auditor is requested by the SFC to report any material inconsistencies between the additional financial information and the audited financial statements in the Audit Questionnaire. Details are set out in Part IV below.~~

## PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

### Introduction

710. This Part of the Practice Note is intended to provide a common approach to reporting by the auditor on regulated entities and to establish clear unequivocal wording of the auditor's reports such that a standard form of wording may be used by the auditor when reporting. One benefit of establishing a standard form of report is that it removes any ambiguity as to the assurance obtained from the auditor about compliance with the requirements of the SFO. Example auditor's reports are set out in Appendix 1 to this Practice Note.

### Management's responsibilities

724. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules addresses matters for which the primary responsibility lies with the management of the regulated entity. The primary responsibilities of management under the Securities and Futures (Accounts and Audit) Rules are, broadly:

- a. to prepare annual financial statements in accordance with generally accepted accounting principles;
- b. to prepare the applicable returns as detailed in section 3(1)(b) or 3(2)(b) (as the case may be) of the Securities and Futures (Accounts and Audit) Rules;
- c. to prepare an Account Disclosure Document which sets out additional financial information (for Licensed Corporations only);
- d. to prepare Analysis of Client Assets (for Associated Entity only);
- e. to ensure that the client asset rules and the Securities and Futures (Keeping of Records) Rules are observed; and
- f. to prepare the Business and Risk Management Questionnaire.

Details are set out in section 3 of the Securities and Futures (Accounts and Audit) Rules.

732. Management should consider the above in their design and maintenance of the systems of control. They should also recognize where appropriate the cost of a particular control, as against its purpose and expected benefit.

743. For the foregoing reasons, different systems and controls may be deemed adequate in different regulated entities, if they provide reasonable assurance that certain control objectives have been achieved. In designing the systems and controls, management would address inter alia the following general control objectives:

- a. the business is planned and conducted in an orderly, prudent and cost-effective manner in adherence to established and documented policies;
- b. transactions and commitments are entered into only in accordance with management's general or specific authority;
- c. client assets are safeguarded and are completely and accurately recorded;
- d. the assets are safeguarded and the liabilities controlled;

- e. the risk of loss from fraud, other irregularities and error is minimized, and any such losses are promptly and readily identified;
  - f. management is able to monitor on a regular and timely basis the regulated entity's business's position relative to its risk exposure;
  - g. management is able to prepare complete and accurate returns for the SFC on a timely basis in accordance with the FRR; and
  - h. issues relating to compliance with the law, codes and guidelines are resolved in a timely manner to the satisfaction of the SFC.
754. In designing a control system, management needs to understand the interaction between manual and computer controls and how they contribute in aggregate to the achievement of the control objectives.

### **Auditor's responsibilities**

765. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules is primarily to provide assurance to the SFC on the financial information provided by the regulated entity and on the systems of control operated by the regulated entity during the financial year covered by the report in relation to the regulated entity's stewardship of client assets.
776. The precise matters on which the auditor is required to report vary according to the nature of the regulated entity's activities. Under section 4(1) of the Securities and Futures (Accounts and Audit) Rules, the auditor is required to report on the matters covered in paragraphs 787 and 798 below. The auditor will prepare an audit report on the regulated entity's financial statements and a compliance report, which is addressed to the board of directors of the regulated entity.
787. In the auditor's report on financial statements, the auditor should give an opinion:
- a. whether the financial statements give a true and fair view; and
  - b. whether the financial statements are in accordance with the records kept by the regulated entity under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules.
798. In the auditor's Compliance Report to management, the auditor should cover:
- a. in the case of a licensed corporation, whether the required returns made up to the last day of the financial year as detailed in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules have been correctly compiled from the records of the licensed corporation or, if not correctly compiled, the nature and extent of the incorrectness;
  - b. in so far as applicable, whether the regulated entity had systems of control in place that were adequate to ensure compliance with the SFC's requirements with regard to client assets during the financial year in question;
  - c. in so far as applicable, whether the regulated entity complied with the Securities and Futures (Keeping of Records) Rules and the client asset rules during the financial year in question; and
  - d. in the case of a licensed corporation, whether there appears to have been any contravention of the FRR by the licensed corporation during the financial year in question.

## General guidance for fulfilling auditor's responsibilities

~~798~~80. In discharging its reporting responsibilities regarding a regulated entity, the auditor must have particular regard to any changes in the SFO and its subsidiary legislation and any other requirements of the SFC in force during the financial year to which the report relates.

810. The nature of the business undertaken by a regulated entity, its size and its particular circumstances will affect the nature and extent of the auditor's work. When planning its work, the auditor assesses the risks associated with the nature of the particular regulated entity. Certain risks will not be applicable to all regulated entities.

824. Other factors that will be considered are:

- a. the scope of licensing in relation to the holding of client assets;
- b. the extent of investment management discretion permitted;
- c. the introduction of new and revised requirements, with reference to the up-to-date Q and A sections on the SFC website;
- d. changes to existing requirements; and
- e. modifications or waivers granted or special conditions imposed by the SFC.

832. In making an assessment of various risk factors, the auditor would normally meet senior management and the Compliance Officer as part of its planning process. It would also consider the following:

- a. operational manuals;
- b. documentation of systems and controls;
- c. compliance monitoring programmes and results;
- d. the records maintained by the regulated entity of any non-compliances and notifications to the SFC that may have occurred during the period under review;
- e. correspondence with the SFC, relating to financial returns and any other matters;
- f. the results of inspection visits made by the SFC;
- g. the register of complaints received from clients during the period under review;
- h. any relevant internal audit reports; and
- i. any unresolved items from previously issued management letters on internal control weakness.

## Auditor's reporting requirements

843. The two separate reports mentioned in paragraph ~~776~~ above are required to be prepared by the auditor in respect of the year under review. They are required to be submitted by the regulated entities to the SFC within four months of their year end. The auditor should take all reasonable steps for its reports to be issued in order for the regulated entities to submit them to the SFC by the specified date.

### **The auditor's report on the financial statements**

854. For a regulated entity which is a Hong Kong incorporated company, the auditor's report contains an audit opinion expressed in true and fair terms pursuant to the Companies Ordinance requirements. It also states whether the financial statements are in accordance with the records kept under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules. An example auditor's report is given in Example 1 of Appendix 1 to this Practice Note.
865. Guidance on the detailed requirements of the Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules, which are also applicable to the auditor's report are set out in paragraphs ~~9089~~ to 1010 below.

### **Compliance Report by the auditor**

867. The Compliance Report setting out the auditor's conclusions on matters set out in paragraph 798 should be addressed to the directors of the regulated entity:
- a. For a licensed corporation, an example Compliance Report is given in Example 2 of Appendix 1 to this Practice Note.
  - b. For an associated entity of an intermediary, an example Compliance Report is given in Example 3 of Appendix 1 to this Practice Note.

#### *The assurance standards followed*

887. The auditor would state that it has conducted its Compliance Reporting engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 *Assurance Engagements Other Audits or Reviews of Historical Financial Information* issued by the HKICPA, and with reference to this Practice Note. It also states that it has carried out such procedures as were considered necessary for its report.

#### *The date of the report*

- ~~8889~~. It is highly desirable that the Compliance Report is dated with the same date as the auditor's report on the financial statements.

### **Guidance on the reporting requirements of the Compliance report**

#### ***Internal control considerations relating to Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules***

- ~~8990~~. In considering the adequacy of systems of control required by the client asset rules and the Securities and Futures (Keeping of Records) Rules, the auditor must recognize the inherent limitations of such systems. These limitations mean that, despite the existence of controls, errors or irregularities may occur and may not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or the risk that the degree of compliance with those procedures may deteriorate.
910. The auditor is required to report whether the regulated entity has satisfied the requirements of the Securities and Futures (Keeping of Records) Rules during the period under review. In order to report on whether the regulated entity has satisfied the requirements of these rules it is envisaged that consideration will be given to whether adequate systems for control of the regulated entity's accounting systems have been maintained.

924. The Securities and Futures (Keeping of Records) Rules set out the basic characteristics of adequate accounting records in general and include some guidance on the contents of specialized accounting records, especially those concerned with client assets. Management, in establishing and maintaining accounting records, and the auditor, in forming a view as to whether adequate records have been kept, will need to refer to the detailed rules relevant to the particular regulated activities.

932. The Securities and Futures (Keeping of Records) Rules require that regulated entities shall in relation to the businesses which constitute any regulated activities for which they are licensed and their associated entities as regards the receipt or holding of client assets in relation to such regulated activities, to keep, where applicable, such accounting, trading and other records as are sufficient to:

*a licensed corporation*

- a. explain, and reflect the financial position and operation of, such businesses;
- b. enable profit and loss accounts and balance sheets<sup>1</sup> that give a true and fair view of its financial affairs to be prepared from time to time;
- c. account for all client assets that it receives or holds;
- d. enable all movements of such client assets to be traced through its accounting systems and, where applicable, stock holding systems;
- e. reconcile, on a monthly basis, any differences in its balances or positions with other persons and show how such differences were resolved;
- f. demonstrate compliance with certain sections of the client asset rules and that it has systems of control in place to ensure such compliance;
- g. enable it readily to establish whether it has complied with the FRR; and
- h. keep records specified in the Schedule to and sections 5, 6, 7(2) or 8 of the Securities and Futures (Keeping of Records) Rules.

*an associated entity*

- a. account for the client assets;
- b. enable all movements of the client assets to be traced through its accounting systems and, where applicable, stock holding systems;
- c. show separately and account for all receipts, payments, deliveries and other uses or applications of the client assets effected by it, or on its behalf, and on whose behalf such receipts, payments, deliveries or other uses or applications of the client assets have been effected;
- d. reconcile, on a monthly basis, any differences in its balances or positions with other persons and show how such differences were resolved;
- e. demonstrate compliance with certain sections of the client asset rules and that it has systems of control in place to ensure such compliance; and
- f. keep certain specific records where applicable.

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<sup>1</sup> Different terms like income statement, statement of comprehensive income, statement of financial position, etc may be used in the auditor's report as long as they are consistent with the titles of the corresponding statements.

943. These records would be kept in such a manner as will enable an audit to be conveniently and properly carried out, and make entries in these records in accordance with generally accepted accounting principles where applicable. There are also particular requirements, over and above those outlined above, for licensed corporations involved in certain regulated activities.
954. Detailed guidance on the control objectives and audit evidence in relation to the auditor's reporting requirements with regard to client assets under the Securities and Futures (Accounts and Audit) Rules are included in Appendix 2 to this Practice Note. The auditor will need to apply judgment in determining the extent and nature of its work which would be based on a good understanding of the regulated entity's systems of control.
965. Underlying any systems of control adopted by a regulated entity is the control environment. Such an environment is created by management having and showing a positive attitude towards the operation of controls and by an organizational framework which enables proper segregation and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the operation of a control is treated as a matter of concern, rather than being largely overlooked, the control environment will be stronger and will contribute to effective systems of control; whereas a weak control environment will undermine detailed controls, however well designed.
976. Within this control environment, the control procedures needed to ensure that the business is conducted to protect investors' interests would be commensurate with the regulated entity's needs and particular circumstances, and also with the inherent risks of the business undertaken. The size of the regulated entity will have an important bearing on the design and formality of the systems and controls. The operating procedures and methods of recording and processing transactions used by small regulated entities often differ significantly from those of large regulated entities. Internal controls which would be relevant to a large regulated entity, may not be practical or appropriate in a small one. Management of a small regulated entity has less need to depend on formal controls for the reliability of the records and other information, because of personal contact with, or involvement in, the operation of the business itself. Nevertheless the need for a positive attitude to the control environment is equally relevant in both small and large regulated entities.
987. Regulated entities frequently have a high degree of computerization. While the control objectives described above apply in both a manual and a computerized environment, there are nevertheless certain requirements of an internal control system peculiar to a computerized environment.
998. Clearly, the emphasis between the two forms of control will be dependent not only on the degree of computerization but also on the circumstances and particular risks of the regulated entity. The greater the degree of computerization, the greater the emphasis that will need to be placed on the general and application controls of the computerized function, as part of the overall systems of internal control. However, the routine processing of a computerized system is generally more reliable than that of a manual system.
99100. Systems of control, including the assignment of responsibilities as set out in the Internal Control Guidelines, need to be clearly documented if they are to be understood, communicated and operated effectively and consistently. Regulated entities and their auditor would consider whether appropriate documentation is a prerequisite of an adequate system.
1010. The effective operation of a control system may be enhanced by an internal audit department or by specific monitoring performed by a compliance department. The existence of such departments and their scope and objectives are matters for management. In assessing the effectiveness of such departments, the auditor will consider the terms of reference of the departments, their independence from operational personnel and management, the quality of staffing and to whom they report in the regulated entity.

**Securities and Futures (Financial Resources) Rules**

1024. Licensed corporations are required to submit to the SFC the following financial returns as referred to in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules made up to the last day of the financial year<sup>2</sup>:

- a. liquid capital computation (Form 1);
- b. required liquid capital computation (Form 2);
- c. summary of bank loans, advances and other credit facilities (Form 3);
- d. Analysis of margin clients (Form 4);
- e. Analysis of collateral received from margin clients (Form 5);
- f. Analysis of rolling balance cash clients (Form 6);
- g. Analysis of client assets (Form 8); and
- h. Analysis of proprietary derivative positions (Form 10).

There is a requirement in the Compliance Report to state that the auditor is not aware of the licensed corporation not complying with the FRR throughout the year. If the licensed corporation has a very low excess liquid capital or is prone to material computational or classification errors this may lead to the auditor deciding to review and test a larger sample of FRR throughout the year. Those material errors may also need to be reported as a breach.

1032. The auditor is required to give an opinion as to whether the financial returns referred to in paragraph ~~404~~ 102 which have been submitted to the SFC have been correctly compiled from the records of the licensed corporation, or if not correctly compiled, the nature and extent of the incorrectness. This involves the auditor in examining the licensed corporation's compilations by reference to the FRR, paying particular attention to those areas most susceptible to management's discretion and having regard to the concept of prudence. Particular care will be exercised in cases where the licensed corporation is operating at a level close to the minimum requirement, since any shortfall (however small) is a contravention of the FRR and results in a higher possibility of window dressing. The auditor would note that the Securities and Futures (Accounts and Audit) Rules do not provide that immaterial discrepancies or reclassifications can be disregarded. Accordingly, the auditor qualifies its opinion where discrepancies and reclassifications are identified in the financial returns regardless of materiality.

1043. If the auditor qualifies its Compliance Report in respect of the financial returns, the auditor either provides the reconciliations or explains the differences. The reconciliations or explained differences are attached to the Compliance Report.

1054. In particular the auditor would check that the reconciliation agrees back to supporting documentation and that the explanations given for any reconciling items are reasonable. Reconciling items commonly relate to audit adjustments made after submission of the financial return.

1065. It is common for a licensed corporation to submit a revised FRR return if errors are noted following the original submission in order to avoid a qualified Compliance Report attaching a reconciliation. An auditor should ensure that he~~#t~~ identifies clearly the FRR he~~#t~~ is commenting on in his~~#s~~ Compliance Report and this should be the latest FRR submitted to the SFC prior to the date of the Compliance Report.

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<sup>2</sup> See Paragraph 106 for the exceptions.



***Securities and Futures (Client Securities) Rules and (Client Money) Rules***

1076. There are essentially two aspects to the auditor's reporting responsibilities for client assets:

- a. whether during the period under review, the regulated entity had systems of control in place that were adequate to enable compliance with the relevant sections of the client asset rules; and
- b. whether during the period under review, the regulated entity complied with the relevant sections of the client asset rules.

1087. Guidance on the control objectives and audit evidence is set out in Appendix 2 to this Practice Note. The auditor applies judgment in determining the extent and nature of its work which is based on the following general requirements:

- a. the auditor understands the business of the regulated entity and the environment in which the regulated entity operates;
- b. the auditor reviews the regulated entity's systems and consider whether these are adequate for control and accounting purposes, and are in accordance with the requirements set out in the Suggested Control Techniques; and
- c. the auditor tests those systems and controls to establish that they are operating effectively.

1098. When planning and carrying out its work, the auditor must always keep in mind the need for audit evidence in relation to the existence of client assets and the accuracy of the regulated entity's records.

1109. Certain licensed corporations do not receive or hold client money or client securities either by choice or by limitation of their licensing condition. It would therefore not normally be necessary for the auditor to make reference to the client asset rules in the Compliance Report. However, the auditor would ensure that such licensed corporations have procedures in place to avoid receipt or holding of client assets. If during the course of the performance of these procedures (as set out in paragraphs 68 - 70 of Appendix 2 to this Practice Note) it comes to the auditor's attention that the licensed corporation has held client assets, it would be necessary for the auditor to make reference to the licensed corporation's compliance with the client asset rules in the Compliance Report. In these circumstances, the auditor will need to revisit the requirements under HKSA 250 and paragraphs 410 and 424 of this Practice Note.

***Qualified Compliance reports***

1110. The auditor may qualify its Compliance Report on grounds other than those which arise in reporting on whether the financial statements give a true and fair view. Where the requirements of the rules upon which the auditor must report have not been met, its report includes a statement specifying the relevant requirements and the respect in which they have not been met, in sufficient detail for the breach or shortcoming to be clearly understood and evaluated. In particular, where the breach relates to a specific rule, the rule number or reference will be stated in the report.

1124. In considering any matter indicating a possible breach of the FRR, client asset rules and the Securities and Futures (Keeping of Records) Rules or inadequate systems of control over client assets, the auditor analyzes the circumstances in order to identify its cause, and establish the action management has taken or intends to take to correct the matter.

1132. If the auditor proposes to include any qualification or adverse statement in the Compliance Report (or its report on the financial statements), it is required under section 157(1)(b) of the SFO, as soon as reasonably practicable after it first proposes the inclusion of the qualification or adverse statement, to lodge with the SFC a report. Details are set out in Part V below.

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

1143. The Securities and Futures (Accounts and Audit) Rules do not provide that trivial breaches can be disregarded. Where small exceptions are discovered, the auditor will need to qualify its opinion, although references can be made to the extent of the breach.

## PART IV - OTHER REPORTING CONSIDERATIONS

### Audit Questionnaire

1154. In order to assist the SFC to carry out its functions of supervising licensed corporations, the auditor would normally on a voluntary basis complete an Audit Questionnaire for submission to the SFC, providing information in relation to the completed audit that is not readily available from the audited financial statements.
1165. Section 158 of the SFO allows the auditor to provide such information to the SFC without the breaching of any duty of confidentiality to the licensed corporations.
1176. The auditor would complete the Audit Questionnaire based on information obtained during the course of its audit of the financial statements covered by the Audit Questionnaire. The SFC does not expect the auditor to extend the scope of its work in order to complete the Audit Questionnaire.

### Account Disclosure Document

1187. The SFC has issued the Account Disclosure Document for Licensed Corporation which sets out additional financial information to be disclosed by licensed corporations. In the Audit Questionnaire the auditor is requested by the SFC to state whether the auditor is satisfied that no material inconsistency between the audited financial statements and the additional disclosure of financial information as required by the Account Disclosure Document for Licensed Corporation came to its attention. ~~The auditor would perform procedures on the additional financial information in accordance with HKSA 720 "Other Information in Documents containing Audited Financial Statements".~~ If the auditor is aware of any material inconsistencies, the auditor states details of such inconsistencies in the Audit Questionnaire.

### Cessation of Activities

119. Where a licensed corporation ceases to carry on all of the regulated activities for which it is licensed, or where an associated entity of an intermediary ceases to be such an associated entity, they are required to submit to the SFC certain documents, including the audited financial statements made up to the date of cessation together with the corresponding auditor reports.
120. The responsibilities of the auditor and the reporting requirements in those audits are generally the same as those discussed in "Part III – Auditor's Reports under the Securities and Futures (Accounts and Audit) Rules".

## **PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION**

### **Introduction**

12148. This Part of the Practice Note is concerned with communications:

- a. by the auditor to the SFC under the obligations established in section 157 of the SFO;
- b. by the auditor to the SFC under the protection of section 158 of the SFO; and
- c. by the SFC to the auditor under section 378(3)(h) of the SFO.

It is also concerned with the related issue of auditor's duty of secrecy under the SFO.

12249. Because of the variety of conditions which might be encountered, the guidance in this Part of the Practice Note is necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with its lawyers when it encounters such circumstances.

1230. Under the SFO the auditor has various statutory responsibilities to report to the SFC. The auditor is automatically protected in making a report in discharge of such a statutory responsibility. Certain provisions of the SFO also provide the auditor with immunity from any liability it might otherwise incur by reason of the auditor making other reports to the SFC which it may consider to be relevant to the functions of the SFC. These responsibilities and avenues available for reporting do not require the auditor to change the scope of its audit work, nor the frequency or timing of its visits.

1244. When the circumstances where reporting may be appropriate are being considered, it should be noted that investments in financial markets carry inherent risks. It is not the purpose of the SFO, nor the duty of the auditor, to protect the investors from the normal risks relating to such investment activities.

1252. The auditor needs to bear in mind that its decision may have to stand up to examination at a future date on the basis of the following considerations:

- a. what it knew at the time;
- b. what it should have known in the course of its audit;
- c. what it should have concluded; and
- d. what it should have done.

The auditor should report to the SFC under section 157 of the SFO promptly and not postpone reporting the breaches until the issuance of the audit report or the compliance report. In addition, taking into account the factors raised above, the auditor should report under section 157 of the SFO in sufficient detail to enable the SFC to understand the nature and circumstances of the situation.

## The auditor to lodge report with the SFC in certain cases

### Sections 157(1)(b) and 157(2) of the SFO

1263. The auditor has a statutory duty to lodge a report with the SFC in the following circumstances:

- a. if it decides to include in its audit report any qualification or adverse statement (SFO section 157(1)(b)). Such a written report is required to be lodged with the SFC as soon as reasonably practicable after the auditor first proposes the inclusion of the qualification or adverse statement; and
- b. if it resigns before the expiration of its term of office, intends not to seek re-appointment or otherwise cease to be the auditor (SFO section 157(2)). Such a notice in writing to notify the SFC is required within one business day of the event, outlining the reasons and any connected circumstances which the auditor considers should be brought to the attention of the SFC, or where there are no such circumstances state the fact.

### Section 157(1)(a) of the SFO

1274. Section 157(1)(a) of the SFO provides that the auditor shall lodge a written report with the SFC, as soon as reasonably practicable after it becomes aware of any "reportable matter". A reportable matter is defined in section 157(3) of the SFO as:

- a. any matter which in the auditor's opinion adversely affects the financial position of the regulated entity to a material extent; or
- b. a failure of the regulated entity to comply with any rules made under section 148, 149 or 151 of the SFO or a failure of the licensed corporation to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it.

1285. These are statutory obligations and this Part of the Practice Note provides the auditor with procedures to follow when such circumstances arise.

1296. Section 157(3) of the SFO includes a failure by the regulated entity to comply with any "prescribed requirement" as a "reportable matter". In addition to the requirements under any of the rules made under sections 148, 149 and 151 of the SFO, it also refers to the requirements under any of the rules made under section 152 of the SFO (provision of contract notes, receipts, statements of account and notifications by intermediaries and their associated entities). It should be noted that the requirements under any of the rules made under section 152 of the SFO are not included as "matters reportable by the auditor under section 157 of the SFO" in section 5 of the Securities and Futures (Accounts and Audit) Rules and therefore the auditor is not required to report to the SFC if there is a failure of the regulated entity to comply with section 152 of the SFO.

#### *Reporting criterion under section 157(1)(a) of the SFO*

13027. The auditor would take the initiative and ensure that a written report on the reportable matter under section 157(1)(a) of the SFO is lodged with the SFC if the conditions specified in paragraph 424–127 above exist. A distinction must be drawn here between an auditor's duty as stated in paragraph 1274(a) and paragraph 1274(b) above. The duty under paragraph 1274(b) is clear and unequivocal: if the auditor becomes aware of a contravention of the requirements which are specified, it is not given any latitude for exercising judgment. The auditor is obliged to make a report. The duty under paragraph 1274(a) is different. The auditor is given the right to form an opinion based on applying criteria as to the materiality of an adverse effect on the regulated entity's financial position in deciding whether reporting would be appropriate.

~~13128~~. The HKICPA has developed a criterion for use by the auditor in deciding to take the initiative in lodging a written report with the SFC under paragraph 1274(a) above. The criterion is that the auditor would lodge a written report with the SFC when it considers it expedient to do so in order for the SFC to protect the interests of investors because there has been a material loss or there exists a significant risk of material loss.

~~1329~~. This criterion can be more fully explained as follows:

- a. there must be a significant adverse occurrence or a change in the auditor's perception of an existing situation, that may include an adverse change in the circumstances of the business; and
- b. the situation described in (a) above has given rise to or has indicated that a reasonable probability exists that it may give rise to:
  - i. a material financial loss to the business which would result in a material deterioration of the licensed corporation's liquid capital position under the FRR; or
  - ii. loss of control over the assets or records.

~~1330~~. Examples of the circumstances encountered in which the situation set out in paragraphs ~~428-131~~ and ~~429-132~~ may be met include:

- a. the auditor discovers a failure by the regulated entity to comply with the provisions of the SFO which may have material consequences; or
- b. there is evidence of imminent financial loss of serious proportions which might cast doubt on the continuing viability of the regulated entity.

*Reporting procedures under section 157(1)(a) of the SFO*

~~1344~~. In circumstances where the auditor concludes that a written report under section 157(1)(a) of the SFO to the SFC is necessary, it would adopt the following procedures, bearing in mind that speed may be of the essence:

- a. The auditor would discuss the matter with the regulated entity (unless the matter relates to suspected or actual instance of fraud and serious misconduct by the management itself) and explain the auditor's statutory duty to lodge a written report with the SFC under section 157(1)(a) of the SFO and that it might be advisable for the regulated entity to make a report direct to the SFC immediately.
- b. The auditor would then immediately lodge a written report with the SFC. The auditor would follow this with a written notification along with a copy of its report to the directors or management to inform them.

~~1352~~. The auditor would note that lodging a written report with the SFC alone may not discharge all its responsibilities. For example, the auditor would consider the implications of the matter giving rise to the report under section 157(1)(a) of the SFO for its opinion on the financial statements, and its conclusions in the Compliance Report.

## Other communications by the auditor

### Statutory protection under section 158 of the SFO

~~1363~~. Section 158 (1) of the SFO provides that:

"... no duty which a person may be subject to as an auditor ... shall be regarded as contravened by reason of his communicating in good faith to the Commission ..., whether or not in response to a request made by the Commission ..., any information or opinion on a matter which (a) he becomes aware of in his capacity as such auditor (whether or not in the course of performing his functions as such auditor); and (b) is relevant to any function of the Commission ...".

~~1374~~. Section 158 of the SFO only gives immunity for the auditor appointed under section 153 of the SFO. It does not cover appointments under section 159 or 160 of the SFO which give the power of appointment to the SFC. However it does extend the immunity to:

- a. an auditor who has ceased to be the auditor but became aware of a matter before his appointment ceased (SFO section 158(2)(a));
- b. an auditor appointed by a former regulated entity (SFO section 158(2)(b)); and
- c. an auditor who has ceased to be the auditor of a former regulated entity before his appointment ceased (SFO section 158(2)(c)).

~~1385~~. Section 158 of the SFO does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the SFC. They provide a mechanism whereby the auditor may make matters known to the SFC with statutory protection from its duty of confidentiality.

~~1396~~. This Part of the Practice Note contains guidance on the circumstances in which matters may be brought to the attention of the SFC by way of a report with statutory protection which falls outside those matters which the auditor is obliged to report (see paragraphs ~~1263~~ to ~~1352~~ above). In interpreting this guidance, the auditor would bear in mind the fundamental objectives of the SFO, which are to ensure that the SFC is able to fulfil its function of safeguarding the interests of investors. The auditor would have regard to any function of the SFC as summarized in section 5 of the SFO.

~~14037~~. Confidentiality is an implied term of auditor's contract with its client, but in certain circumstances and under conditions specified in section 158 of the SFO it does not prevail, since the auditor of a regulated entity is entitled to communicate in good faith to the SFC information or opinion on a matter which it becomes aware of in its capacity as the auditor of the regulated entity and is relevant to any function of the SFC, without the duty of confidentiality owed to the client being regarded as having been contravened.

~~14138~~. The matters which may be communicated under section 158 of the SFO depend on the functions of the SFC. Any matters relevant to any of its functions under the SFO may be communicated to the SFC.

~~14239~~. Matters which may be reported under the protection of section 158 of the SFO will only arise in circumstances other than where the auditor is under a statutory duty to report under section 157 of the SFO. Considerable care needs to be taken in disclosing matters arising during any tripartite meeting with the SFC as the auditor's knowledge of these matters may have been obtained while assisting the SFC rather than in its capacity as the auditor (see paragraph ~~443-146~~ below).

1430. Examples of circumstances in which the auditor may communicate any matter to the SFC under section 158 of the SFO include:

- a. the auditor considers investors have incurred, or are at significant risk of incurring, a material loss as a result of the regulated entity carrying on business in a manner that is not fit and proper;
- b. there is evidence of:
  - i. fraud, dishonesty or serious incompetence; or
  - ii. serious failure to observe rules for the conduct of the regulated entity;
- c. it has come to the attention of the auditor that the procedures, records or systems fail significantly to comply with, or to demonstrate compliance with, conduct of business requirements to which the regulated entity is subject (except in respect of client assets which are covered in section 157 of the SFO); and
- d. the position is such that because of a significant risk which is material to the collective interests of investors, the investors' interests would be better safeguarded if the SFC were aware of the position, even if only to organize protective action.

1444. Clearly the potential nature of matters which may be reported is very wide, but as explained in paragraph 444-147 below this does not, of itself, require the auditor to extend the scope of its work in order to discover matters and it will only be in exceptional circumstances such as those described in paragraphs 1574 and 1585 that it may choose to seek statutory protection.

1452. Any protected communication can be made either on the auditor's initiative or in response to a request from the SFC for information. The auditor would cooperate with the SFC and respond to any requests from the SFC for information, provided it has no reason to doubt that the request is relevant to the SFC's functions. The auditor may communicate a matter to the SFC with the protection of section 158 of the SFO regardless of the source of that information, provided it became aware of the matter in its capacity as the auditor of the regulated entity and it does so in good faith.

1463. Matters of which the auditor becomes aware "in its capacity as the auditor" may not be restricted to those matters identified during the course of the audit work by the auditor and members of the audit team. The auditor or members of the audit team may become aware of a matter which is relevant to the functions of the SFC during the course of its carrying out work for the regulated entity other than audit work or through private discussions on social or other occasions, in which case the information will be known to them as individuals. In circumstances which suggest that a matter would be reported to the SFC if knowledge of it had been obtained in the capacity as the auditor, it would be prudent to make enquiries in the course of the audit work in order to establish whether this is the case from information obtained in this capacity. In addition, a matter which is relevant to the functions of the SFC and which is identified during the course of work for the regulated entity by another partner (or member of staff) such as a management consultant or tax partner may be deemed to be known to the auditor (see also paragraph 444-147 below).

1474. The auditor cannot be expected to be aware of all circumstances which, had it known of them, would have led them to exercise its right to communicate under section 158 of the SFO. This section does not require the auditor to change the scope of its audit or other work for the regulated entity, nor the frequency or timing of its visits. The auditor has no obligation to seek out grounds for making a report under section 158 of the SFO, the section does not place an obligation on the auditor to conduct its work in such a way that there is reasonable certainty that it will discover a matter upon which the SFC may need to act. It is only when the auditor does become aware in the ordinary course of this work of such a matter, or of circumstances which suggest the existence of such a matter, that it would consider using the protection of section 158 of the SFO.



1485. The SFC recognizes that it would not be appropriate for the auditor to report information which it has obtained or matters which it has identified through its professional relationship with another client, even though the information obtained or the matters identified may relate to a regulated entity.
1496. The auditor would need to realize that section 158 of the SFO will not provide protection where it could be held to have acted maliciously or in bad faith or if the information reported is outside the scope of the section. The SFO does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by their action in reporting to the SFC. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of its report are such as to secure the protection of section 158 of the SFO and that it only includes relevant material.
15047. The auditor is protected, however, even if the information which it communicates subsequently falls short of proof, or the opinion which it communicates cannot be verified. The auditor who can demonstrate that it has acted reasonably and in good faith in informing the SFC of any information or opinion on a matter which it thinks has occurred would not be held in breach of duty to its client even if, after an investigation, it were found there was not a matter which needed to be reported. These are areas where the auditor may wish to consider taking legal advice before making a report.
15148. Whilst no breach of statutory duty might arise, it should be appreciated that there is no protection given by the SFO if the auditor, after becoming aware of an occurrence, fails to report, promptly, or at all, to the SFC. Furthermore, the auditor would need to recognize that speed of reporting is likely to be important in order to enable the SFC to protect the interests of investors.

#### **Tripartite meetings**

15249. As part of the SFC's system of supervision of regulated entities, meetings involving the SFC, the regulated entity and its auditor may be called by either the SFC, or the regulated entity possibly at the auditor's suggestion.
1530. In such meeting, the auditor would be expected to discuss with the SFC the affairs of the regulated entity including:
- a. the presentation and content of the financial statements;
  - b. the scope, conduct and outcome of the annual audit;
  - c. the scope, conduct and outcome of any report under section 158 of the SFO;
  - d. any points raised in the management letter which relate to the SFO;
  - e. explanations for, the reason for and nature of a qualified auditor's report or of a change in a previously reported intention to qualify an auditor's report;
  - f. any step or course of action which may be necessary in the light of the reports, for example, the commissioning of a more detailed report in a particular area (under section 159 or 160 of the SFO); and
  - g. matters raised by the SFC or those which the regulated entity or the auditor have drawn to its attention since any previous meeting, including how such matters have been resolved to the satisfaction of the auditor or have been reflected or treated in the financial statements.

### **Reporting via the regulated entity**

1544. Where the auditor becomes aware of a matter which, in its professional judgment, it considers is not required to be reported under section 157 of the SFO but ought to be reported to the SFC, it would consider the facts and, unless inappropriate in the circumstances (described in paragraph ~~154~~157 below), discuss the matter with the management.
1552. It is important for the auditor to act in a manner that will maintain its professional relationship with its client. Normally, therefore, the auditor would ask the regulated entity to draw matters about which it is concerned to the attention of the SFC.
1563. Where the regulated entity will not itself inform the SFC of a matter, having been advised to do so by the auditor, or where it has not been done within the period of time specified, or where there is no adequate evidence that the client has properly reported the matter in question, the auditor would make such a report direct to the SFC.

### **Reporting direct to the SFC**

1574. In exceptional circumstances, where the auditor doubts whether management is fit and proper person to carry on business as a regulated entity and it would be in the interest of protecting investors that the management of the regulated entity would not be informed in advance, the auditor would report direct to the SFC after first considering the appropriateness of taking independent legal advice. Examples of these circumstances include:
- a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where it believes that a fraud or other irregularity has been committed by the directors or senior management of the regulated entity, or it has evidence of the intention of directors or senior management to commit such a fraud or other irregularity; or
  - b. where there has been an occurrence which causes the auditor no longer to have confidence that the directors or senior management will conduct the business of the regulated entity in a prudent manner so as to protect the interests of investors, e.g. where it has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the affairs of the business or its clients, or it has evidence of their inclination so to act.

1585. The auditor would also report direct to the SFC when speed is of the essence. For example, when it becomes aware that the regulated entity may be about to cease being licensed, the auditor would consider the need to disclose to the SFC any information in its possession relevant to its functions without delay. The fact of such impending cessation of licence may bring forward the desirability of disclosing matters to the SFC, as it is easier for the SFC to take appropriate action while the entity is still licensed, particularly where such matters bear on the security of third party interests.

### **The auditor's duty of secrecy**

1596. Section 378 of the SFO imposes a duty of secrecy upon any "specified person", within the meaning of that term in section 378(15). The auditor is bound by the duty of secrecy once it performs any function under or carries into effect any of the provisions of the SFO or assists another person in the performance of any function under or in carrying into effect any such provisions.
16057. The precise scope of an auditor's statutory duty of secrecy is not definitive but is likely to include:
- a. any matter which, in the auditor's opinion, adversely affects the financial position of the regulated entity to a material extent and which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;

- b. any evidence of the regulated entity's failure to comply with any rules made under section 148, 149 or 151 of the SFO, or any evidence of the licensed corporation's failure to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it, which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;
- c. the auditor's decision to resign before the expiration of its term of office, the auditor's decision not to seek re-appointment, or if the auditor otherwise ceases to be the auditor, and any reason for such decision which is communicated to the SFC under section 157(2) of the SFO;
- d. any reason for including any qualification or adverse statement in the auditor's report on the regulated entity's financial statements (SFO section 157(1)(b)) which is communicated to the SFC to the extent that such reason is not self-evident from the contents of the report itself;
- e. any communication by the auditor to the SFC under section 158 of the SFO, which is a communication of information or opinion on a matter which is relevant to any function of the SFC of which it becomes aware in its capacity as the auditor, whether or not it is at the time of such communication still the auditor of the regulated entity concerned; and
- f. any communication by the SFC to the auditor under section 378(3)(h) of the SFO (see paragraphs ~~462-165~~ - ~~464-167~~ below).

~~16158~~. Application of section 378 of the SFO would therefore prevent the auditor from communicating any matters such as those referred to in paragraph ~~457-160~~ above to any parties other than the SFC except under certain circumstances as discussed in paragraphs ~~16259~~ and ~~1630~~ below in relation to the matters mentioned in paragraph ~~16057~~(c) above. It should be emphasised that application of section 378 of the SFO would also prevent the auditor from communicating information that is subject to the duty of secrecy to the regulated entity concerned except for information which the regulated entity already knows.

~~16259~~. Section 210A(2) of the Companies Ordinance states that an auditor's notice of resignation shall not be effective unless it contains either (i) a statement to the effect that there are no circumstances connected with its resignation which it considers should be brought to the notice of the members or creditors of the company; or (ii) a statement of any such circumstances as aforesaid. Thus, the incoming auditor and members or creditors of a regulated entity may be informed by the outgoing auditor regarding its reasons to resign, not to seek re-appointment or otherwise cease to be the auditor. Disclosure of such information by the outgoing auditor of a regulated entity under the provisions of the Companies Ordinance is permitted under section 378(2)(e) of the SFO without breaching the duty of secrecy under section 378 of the SFO since the disclosure is made in accordance with a law.

~~1630~~. In complying with a request by the incoming auditor to provide professional clearance which is required under HKICPA Code of Ethics for Professional Accountants, the outgoing auditor may communicate the matters referred to in paragraph ~~457-160~~(c) to the incoming auditor. The outgoing auditor is considered to be doing this for the purposes of carrying into effect the provisions of section 153 of the SFO in order that the incoming auditor can accept nomination as the auditor of the regulated entity under section 153 of the SFO.

~~1644~~. Under this Practice Note, the auditor would prepare two auditor's reports separately in respect of reporting on the financial statements (see paragraph ~~84-85~~ above) and compliance reporting (see paragraph ~~86-87~~ above). Since the Compliance Report by the auditor is for filing with the SFC only and should not be made available to any other parties including the shareholders of the regulated entity, the auditor can disclose any contraventions by the regulated entity of the requirements referred to in paragraph ~~457-160~~(b) in the Compliance Report without breaching the duty of secrecy under section 378 of the SFO.

## **Communications by the SFC to the auditor under section 378(3)(h) of the SFO**

1652. Section 378(3)(h) of the SFO empowers the SFC to disclose confidential information to the auditor of regulated entities for the purpose of enabling or assisting the SFC to perform its functions under the SFO without the consent of the person from whom it is received or to whom it relates. It should be noted that disclosure by the SFC of confidential information to the auditor is to the auditor only; it is not free to pass that information to others, such as its client regulated entity without the consent in writing of the SFC.
1663. The SFC will generally take the initiative in bringing a matter to the attention of the auditor of a regulated entity under the provisions of section 378(3)(h) of the SFO if it considers disclosure is necessary to enable or assist the SFC to perform its functions under the SFO, ~~and believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of its audit report or the way in which it carries out its reporting responsibilities.~~ Where the SFC discloses confidential information to the auditor under section 378(3)(h) of the SFO, it will generally inform the auditor whether it has informed the regulated entity's management of the matter and, if so, whom.
1674. If the auditor is not informed by the SFC of any such matter, it is entitled to assume that the SFC has no such disclosure to make. Accordingly, there is no need for the auditor to request the SFC to confirm this.

## APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS

### Example 1 - auditor's report on financial statements - regulated entity

#### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF ABC SECURITIES LIMITED

(incorporated in Hong Kong with limited liability)<sup>1</sup>

#### Report on the Financial Statements

We have audited the financial statements of ABC Securities Limited ("the Company") set out on pages ..... to....., which comprise the [balance sheet][statement of financial position]<sup>2</sup> as at 31 December 200X1,<sup>3</sup> and the [income statement][statement of comprehensive income]<sup>2</sup>, [statement of changes in equity or statement of recognised income and expense] and [cash flow statement][statement of cash flows]<sup>2</sup> for the year then ended, and a summary of significant accounting policies and other explanatory notes information.

#### Directors' ~~Responsibility~~ for the ~~Financial s~~Statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. ~~This responsibility includes designing, implementing and maintaining internal control relevant to and for such internal control as the directors determine is necessary to enable the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.~~ In addition, the directors also have a responsibility to ensure that the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

#### Auditor's ~~Responsibility~~

Our responsibility is to express an opinion on these financial statements based on our ~~audit~~ audit<sup>4</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as ~~to~~ about whether the financial statements are free from material misstatement, and whether the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of

<sup>1</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>2</sup> Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

<sup>3</sup> For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities.

<sup>4</sup> The auditors may consider it appropriate to clarify to whom ~~it is~~ they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

*Opinion*

In our opinion, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X<sub>1</sub> and of its [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

**Report on matters under the Hong Kong Securities and Futures (Keeping of Records) Rules and Hong Kong Securities and Futures (Accounts and Audit) Rules of the Hong Kong Securities and Futures Ordinance**

In our opinion, the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

## Example 2 - compliance report by the auditor - licensed corporation

### COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC SECURITIES LIMITED

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*]<sup>2</sup> for submission by the company to the Hong Kong Securities and Futures Commission ("SFC").

#### Respective responsibilities of directors and auditor

In relation to this Compliance Report, the directors have a responsibility to ensure that:

- a. each of the returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] is correctly compiled from the records of the company;
- b.<sup>1</sup> the company has systems of control in place that are adequate to ensure compliance with:
  - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
- c. the company has complied with:
  - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- d. the company has complied with the Hong Kong Securities and Futures (Financial Resources) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusions 1(a) and 1(c) below, we have performed such procedures as we considered necessary.

[In relation to our conclusion 1(b) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.]<sup>1</sup>

In relation to our conclusion (2) below, we are not required to perform any procedures to search for instances of contravention of the Hong Kong Securities and Futures (Financial Resources) Rules.

### **Inherent limitations**

Systems of controls designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Such measures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust.

### **Conclusion**

Based on the foregoing:

1. in our opinion:
  - a. the company has correctly compiled the attached returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] from the records of the company;
  - b.<sup>1</sup> during the year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
    - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - ii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
  - c. during the year ended [*year end date*], the company has complied with:
    - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
    - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
2. during the year ended [*year end date*], we are not aware of any instances where the company has contravened the Hong Kong Securities and Futures (Financial Resources) Rules.



## Use of this report

This report is intended solely for submission by the company to the SFC and is not intended to be, and should not be, used by anyone for any other purpose.

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable where the licensed corporation does not hold client assets. Refer to paragraph 68 of Appendix 2 for more guidance.*

Where the licensed corporation does not hold assets, the auditor is encouraged to include either one of the following paragraphs after the first paragraph of the example compliance report:

- (a) The licensed corporation is subject to the licensing condition that it shall not hold client assets. *[This paragraph is applicable to licensed corporations / associated entities who are not licensed to hold client assets.]*
- (b) The licensed corporation is permitted to hold client assets however no client assets were held during the year. *[This paragraph is applicable to licensed corporations / associated entities who are licensed to but does not hold client assets.]*

*Note 2: For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities.*

### **Example 3 - compliance report by the auditor - associated entity of intermediary**

#### **COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC NOMINEE LIMITED**

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*]<sup>2</sup> for submission by the company to the Hong Kong Securities and Futures Commission (SFC).

#### **Respective responsibilities of directors and auditor**

In relation to this Compliance Report, the directors have a responsibility to ensure that:

- a. the company has systems of control in place that are adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### **Basis of conclusion**

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusion (a) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Technique and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.

In relation to our conclusion (b) below, we have performed such procedures as we considered necessary.

### **Inherent limitations**

Systems of controls designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Such measures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust.

### **Conclusion**

Based on the foregoing, in our opinion:

- a. during the year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. during the year ended [*year end date*], the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

### **Use of this report**

This report is intended solely for submission by the company to the SFC and is not intended to be, and should not be, used by anyone for any other purpose.

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable in the case of an associated entity of a registered institution.*

*Note 2: For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the date that the entity ceases to be an associated entity.*

## APPENDIX 2 - CLIENT ASSETS

### INTRODUCTION

1. This Appendix provides more detailed guidance to the auditor on the work normally carried out in order to form an opinion on client assets in the auditor's reporting under the SFO. It provides guidance on the following rules:
  - a. Securities and Futures (Client Securities) Rules (Client Securities Rules);
  - b. Securities and Futures (Client Money) Rules (Client Money Rules);
  - c. Securities and Futures (Keeping of Records) Rules (Keeping of Records Rules); and
  - d. Securities and Futures (Accounts and Audit) Rules.

For the purpose of this Appendix the term "rules" means any of the above applicable rules.

2. The main purpose of the rules in relation to client assets is to ensure that the regulated entity safeguards client assets. A further purpose is to ensure that, in the event of insolvency of the regulated entity, client assets are protected from the claims of its general creditors and, in the case of client money, from any right of set off by institutions which hold the money.
3. The rules require a regulated entity to maintain a high standard of custodianship and associated record keeping. Management of a regulated entity is responsible for establishing and maintaining adequate accounting records and systems and controls. In this regard, the SFC has issued guidance to licensed corporations in the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules. This recognizes the position of trust under which client assets are held.
4. This Appendix is separated into three sections as follows:
  - a. client securities;
  - b. client money; and
  - c. no client assets.

The sections on client securities and client money also set out the relevant planning considerations.

5. This Appendix is to assist the auditor in determining the scope of the work for each individual audit. However it is not intended to limit or replace individual professional judgment, initiative and vigilance. Audit procedures are designed to meet the requirements of the particular situation, giving careful consideration to the size and type of regulated entity and the system of internal accounting control; this is a matter that requires the exercise of professional judgment in the light of the circumstances of each particular case.
6. Where the auditor discovers that the systems have failed or material differences have arisen, it considers the implications these may have on other areas of its work, on its reporting obligations and, in particular, on the "truth and fairness" of the financial statements.

## CLIENT SECURITIES

### Introduction

7. Client securities, for the purpose of the Client Securities Rules, are securities that are:
  - a. either
    - i. listed or traded on a recognised stock market; or
    - ii. interests in a collective investment scheme authorized by the SFC under section 104 of the SFO; and
  - b. received or held in Hong Kong by or on behalf of
    - i. a licensed corporation in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or
    - ii. an associated entity of an intermediary in relation to the conduct of any regulated activity.

These securities may be held in the form of collateral.

8. The Client Securities Rules do not apply to client securities of a licensed corporation that are in an account established and maintained by a client of the licensed corporation, in that client's name, with a person other than the licensed corporation or an associated entity of the licensed corporation. The Client Securities Rules do not apply to client securities that are received or held outside Hong Kong by a licensed corporation or its associated entity.
9. For the particular regulated activity, the auditor needs to understand what may constitute client securities that are covered by the Client Securities Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client securities, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Securities Rules as a result.

### Planning

10. The auditor's work on client securities will be planned in relation to three reporting requirements. For client securities, the main areas that need to be addressed by the auditor, to enable them to fulfill its reporting requirements, are:
  - a. whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with the sections 4(4), 5, 10(1) and 12 of the Client Securities Rules;
  - b. whether during the period under review, the regulated entity has complied with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules; and
  - c. whether during the period under review, the regulated entity has complied with section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client securities.
11. The control objectives that a regulated entity administering or holding client securities or securities collateral will need to meet and the evidence that may be available to the auditor upon which it can base its conclusions are outlined below. They are only indicative.
12. Not every regulated entity, particularly a smaller one, will be able to meet all these objectives through the establishment of formal controls and segregation of duties. In consequence, not all the evidence indicated below will be available in every case.

13. This does not necessarily mean that the regulated entity has weak controls or that there is insufficient evidence for the auditor to give a conclusion. The regulated entity may well have adequate controls due to close supervision by the management, taking into account the low volume of client securities handled.
14. In some cases, therefore, the auditor may place greater reliance on observation and enquiry for its audit evidence than inspection of documentation. In doing so, it needs to bear in mind that undocumented systems are more prone to error and fraud, and that its presence and enquiries may influence the manner in which procedures are operated at that time.

#### **Adequate systems of control - Timely renewal of standing authorities (section 4(4))**

##### **Control objectives - Timely renewal of standing authorities**

15. The main factors that will be considered are:
  - a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;
  - b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
  - c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

##### **Evidence - Timely renewal of standing authorities**

16. The main factors that will be considered are:
  - a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current standing authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.

#### **Adequate systems of control - Deposit or registration of client securities and securities collateral (section 5)**

##### **Control objectives - Deposit or registration of client securities and securities collateral**

17. The main factors that will be considered are:
  - a. whether registerable client securities are registered in a name permitted by the rules;
  - b. where client securities are deposited in the same name as that used for the intermediary's house positions, that the client securities are deposited in a designated account different from that in which its house positions are deposited;
  - c. securities held as collateral can be separately identified;

- d. arrangements for releasing documents under stock lending and borrowing arrangements are in accordance with the rules;
- e. satisfactory arrangements for ensuring that the client securities were held or securities collateral kept after receipt in a segregated account or registered in the name of the client from whom or on whose behalf the client securities have been received, or the intermediary (applicable to securities collateral only) or associated entity;
- f. satisfactory arrangements for ensuring that where client securities and securities collateral are deposited in safe custody, that the financial institutions, custodians or other intermediaries in question are appropriately authorized, approved or licensed as appropriate;
- g. satisfactory arrangements for withdrawal or disposal of client securities and securities collateral to be made to or by the client, or to or by any authorized party as specified in sections 5 and 6 of the Client Securities Rules upon the circumstances or under discretionary powers given in the client agreement;
- h. risk assessments to be carried out on all custodians to assess the risk of placing client securities and securities collateral with a third party;
- i. written arrangements between the intermediary or associated entity and the custodian covering at least the minimum requirements of the rules; and
- j. an adequate system to ensure that statements are sent to clients at required intervals, and that such statements properly reflect the regulated entity's records.

**Evidence - Deposit or registration of client securities and securities collateral**

18. The main factors that will be considered are:
- a. written instructions from clients stating the manner in which their securities are to be registered; these instructions may be set out in standard client agreements;
  - b. written procedures setting out how each security is to be identified so as to reflect the client's entitlement to that security (e.g. registered in the client's name);
  - c. where client securities are registered in the name of the intermediary or an associated entity, that an appropriate record of the interests of individual clients is maintained;
  - d. clear segregation of client securities from other securities;
  - e. separate registers maintained of securities held as collateral;
  - f. evidence of appropriate authority to engage in stock lending arrangements, given to the regulated entity by the clients concerned;
  - g. separate records of all such transactions sufficient to show the details of the stocks lent at any time and the collateral held;
  - h. proper segregation of duties which ensure each area is staffed by people independent of any other operations and password controls;
  - i. qualifications and experience of senior management;
  - j. strong boxes, fire-proof rooms and safes, restricted access via password controlled doors or limited access to keys, especially where important documents like securities certificates, were kept in the office premise;

- k. regular stock reconciliations performed for each stock segregated account against third party supporting documents;
- l. follow up actions taken by the licensed corporation on any reconciling or unusual entries in the stock records, particularly negative stock balances;
- m. evidence of spot checks of the custodian area by the compliance or internal audit department;
- n. written procedures stating how custodian staff are to process the movement of securities and what is required in the form of authorization;
- o. evidence of procedures for selection of external financial institutions, custodians or other intermediaries to ensure that they are eligible and suitable to hold client securities and securities collateral in safe custody;
- p. results of a risk assessment process including external information on credit rating, financial results etc. of the custodian and internal information on customer service received;
- q. letters of agreement with custodians stating the terms under which they are operating;
- r. file copies of statements sent to clients, which agree with the records; and
- s. procedures and controls (e.g. completed checklist) to ensure that all clients receive a statement (where required).

**Adequate systems of control - Depositing and transferring client securities and securities collateral (section 10(1))**

19. Under section 10(1) of the Client Securities Rules a regulated entity is required to take reasonable steps to ensure that client securities and securities collateral of the intermediary are not:
- i. deposited;
  - ii. transferred;
  - iii. lent;
  - iv. pledged;
  - v. repledged; or
  - vi. otherwise dealt with,

except as provided in Part 2 of the Client Securities Rules.

The relevant elements of the Client Securities Rules in Part 2 (covering sections 5, 6, 7, 8 and 9) in summary cover the following:

- a. *Section 5 - requirements for deposit or registration of client securities and securities collateral*

Unless client securities and securities collateral are registered in the name of the client, or the associated entity (or the intermediary in the case of securities collateral):

- i. client securities are:



- deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities;
- ii. securities collateral is:
- deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities; or
  - deposited in an account in the name of the intermediary or associated entity with authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities.

*b. Section 6 - dealings with client securities and securities collateral*

A regulated entity may deal with client securities or securities collateral in accordance with:

- i. an oral or written direction to sell or to settle such a sale order;
- ii. a written direction to withdraw the client securities or securities collateral (where required under section 5);
- iii. a standing authority, except where this will result in:
  - a transfer of client securities or securities collateral to an account in Hong Kong other than an account referred to in section 5 or otherwise result in the intermediary, associated entity or a related corporation of the intermediary having the benefit or use of the client securities or securities collateral;
  - a transfer of the client securities or securities collateral to an officer or employee, unless he is the client in question; or
  - an unconscionable transaction in the sense of the Unconscionable Contracts Ordinance.

Where a licensed corporation is licensed for asset management, with the written agreement of the client, ~~client securities may be withdrawn from a trust account or client account, or where client securities that have been registered in the name of the client or an associated entity they can be sold or used to settle a sale order on behalf of the client~~ the licensed corporation may withdraw client securities from a trust account or client account, or deal with client securities that have been registered in the name of the client or an associated entity, for the purpose of selling the securities or settling a sale order on behalf of the client.

Where there is a liability owed by or on behalf of a client, with that client's written agreement, a licensed corporation may dispose, or initiate a disposal by any of its associated entities, of any of the client securities or securities collateral in settlement of that liability.

*c. Section 7 - treatment of client securities and securities collateral by intermediaries licensed for dealing in securities and their associated entities*

With a standing authority a licensed corporation licensed for dealing in securities may:

- i. apply any of the securities or securities collateral pursuant to a securities borrowing or lending agreement;
  - ii. subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, deposit any of the securities collateral in question with an authorized financial institution as collateral for financial accommodation provided; or
  - iii. deposit any of the securities collateral in question with a recognised clearing house or another intermediary licensed or registered for dealing in securities as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.
- d. *Section 8 - treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities*

Subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, with a standing authority a licensed corporation licensed for securities margin financing may deposit any of the securities collateral that it receives with an authorized financial institution or an intermediary licensed for dealing in securities as collateral for financial accommodation provided to the licensed corporation.

- e. *Section 8A – repledging*
- i. A regulated entity is required to ascertain the closing aggregate market value of the repledged securities collateral for each business day does not exceed 140% of its aggregate margin loan on the same date;
  - ii. If such 140% limit has been exceeded on any business day, the regulated entity is required to withdraw any excess to reduce such ratio to below the limit by the end of the next business day.
- f. *Section 9 - treatment of securities collateral by intermediaries licensed for dealing in futures contracts and their associated entities*

With a standing authority a licensed corporation licensed for dealing in futures contracts may deposit any of the securities collateral that it receives with a recognised clearing house or an intermediary licensed or registered for dealing in futures contracts as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.

**Control objectives - Depositing and transferring client securities and securities collateral**

20. The control objectives that have been included in paragraph 17 above apply here. Additional factors that will be considered are:
- a. written procedures in place covering client dealing and transfer instructions;
  - b. controls provide assurance that client instructions are authorized prior to being actioned;
  - c. standing authorities are valid and current;
  - d. transfers of client securities and securities collateral are made to appropriate authorized accounts;
  - e. controls provide assurance that at the end of each business day repledged securities that exceed 140% of aggregate margin loans are promptly identified and rectification action is taken within the following business day in accordance with the rules~~does not exceed 140% of aggregate margin loans;~~ and

- f. where a client has failed to deliver the stock to the licensed corporation to settle his sale order, the securities of other clients are not used to settle the obligations of the client except as provided in Part 2 of the Client Securities Rules.

**Evidence - Depositing and transferring client securities and securities collateral**

- 21. The main factors that will be considered are:
  - a. availability of up-to-date written procedures covering the handling of client instructions;
  - b. evidence that client instructions are verified as authentic and valid before being actioned;
  - c. evidence that client standing orders are checked that they are current and cover the transaction in question each time they are used;
  - d. evidence that where appropriate client securities and securities collateral are only transferred to or deposited with authorized financial institutions, approved custodians or other intermediaries licensed for dealing in securities;
  - e. where the licensed corporation has both cash clients and margin clients, the auditor should check whether separate designated accounts are maintained;
  - f. where client securities are maintained through CCASS, to determine whether securities received are allocated and transferred to the appropriate account within the timeframe as specified by the rules;
  - g. whether the licensed corporation has taken effective actions to follow up on any negative stock balance in its stock records and client ledger; and
  - h. the maximum amount of securities that the licensed corporation is permitted under section 8A of the Client Securities Rules to repledge is calculated on an ongoing basis and compared with the aggregate value of securities actually repledged, and rectification action is carried out within the statutory timeframe for any breach of the limit.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 12)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

- 22. The main factors that will be considered are:
  - a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined in section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

23. The main factors that will be considered are:
- a. evidence that the business has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

**Compliance with the rules**

24. The work that the auditor will have performed as outlined above in relation to determining whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules is likely to also enable it to report on whether during the period under review, the regulated entity has complied with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules.

Depending on the results of the work on the systems of control, some additional testing is likely to be required to enable the auditor to issue its opinion on the regulated entity's compliance with the rules during the period under review.

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

**Adequate accounting records have been maintained**

**Control objectives - Adequate accounting records have been maintained**

25. The main factors that will be considered are:
- a. proper and prompt recording of the movements of documents (this includes all documents, including those relating to the regulated entity's own securities as there is a risk of teeming and lading and having client documents mixed with the regulated entity's own documents);
  - b. proper and prompt recording of all purchases and sales of securities on behalf of clients;
  - c. records in agreement with the statements sent to clients of assets held on their behalf;
  - d. reconciliations carried out in accordance with the rules; and
  - e. proper and prompt accounting for benefits, such as bonus or scrip issues accruing to clients.

**Evidence - Adequate accounting records have been maintained**

26. The main factors that will be considered are:
- a. evidence that documents of title are recorded immediately on receipt;
  - b. evidence that documents of title are not released from the regulated entity's control to clients, registrars, brokers, etc. without the records being amended;

- c. records kept in respect of any document clearly setting out the date of receipt and despatch of the document, the nature of the document, the client to whom the document relates, and the nature, amount and nominal value of the securities to which the document relates;
  - d. evidence that statements are sent to clients at the required intervals, made up to the appropriate date, and properly specifying the documents held. In this context, the auditor may consider obtaining direct confirmation from clients;
  - e. evidence that correspondence from clients querying statements (including client complaints) and any other queries have been dealt with properly and promptly;
  - f. evidence that benefits such as dividends or scrip issues are collectively and correctly allocated to each client;
  - g. evidence that reconciliations have been carried out in accordance with the rules (for more detailed guidance on reconciliations see paragraphs 28 to 36 below); and
  - h. circularisation of account balances in accordance with paragraph 27 below.
27. The auditor exercises its professional judgment to determine whether and how to go about the performance of a circularisation of clients' account balances. The SFC has issued a list of matters which may be taken into account by the auditor in conducting a circularisation of clients' account balances:
- a. the auditor would exercise its judgment in determining sufficient coverage of samples over the total population of clients' accounts both in terms of number of clients and the money value of clients' assets;
  - b. a risk-based approach should be adopted for sampling client accounts for circularisation whereby greater emphasis is placed on accounts which are more susceptible to misstatement or frauds, such as accounts under an arrangement to hold mail or to direct mail to the address of management or staff of the licensed corporation, inactive and dormant accounts etc;
  - c. appropriate audit steps should be taken to ensure the completeness of the list of clients from which samples are drawn;
  - d. confirmation would be prepared in language that the clients of the regulated entity are familiar with;
  - e. confirmation would be directly sent to and received from clients. Clients would be provided with convenient means of responding to the auditor;
  - f. be aware of any client enquiries regarding any discrepancies in their account balances;
  - g. the auditor would independently select samples for circularisation;
  - h. the auditor should ensure that the client particulars (such as the name and address of the client) stated in statements of account to be sent to the clients for confirmation agree to the licensed corporation's latest client information. Furthermore, the auditor should also ensure that the account balances and securities holding in the statements of account sampled for confirmation are consistent with the licensed corporation's relevant records. For example, holdings in each stock as stated in the statements of account should be checked against the underlying accounting records and stock ledgers, which should be reconciled with custodians' statements and/or physical stock count results with discrepancies properly followed up.

- i. to improve the number of replies it is advisable to send the confirmation out as close as possible to the date that the licensed corporation has sent out its monthly statements.
- j. the auditor to determine appropriate procedures in assessing the reliability of the confirmation letters received such as verifying client signatures on the confirmation against client agreements and/or directly calling the clients to verify the agreed balances on a sample basis; and
- k. adequate and timely follow-up procedures for the non-reply confirmations would be carried out such as considering sending reminders or directly calling the non-reply clients etc. and/or reviewing a sample of trade orders and withdrawals of funds and securities recorded in their accounts.

### **Reconciliations**

28. The requirement to carry out reconciliations is set out in the Keeping of Records Rules. Further guidance on client asset reconciliation is set out in the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules.

*Control objectives - Reconciliation of client securities - Physically held client securities*

29. The main factors that will be considered are:
- a. physical counts and reconciliations of all securities performed with at least the frequency and in the manner required by the rules, and by staff (in so far as possible) independent of the custodian department;
  - b. procedures planned and implemented to ensure that the count of client title documents is accurate;
  - c. timely clearance of reconciling items; and
  - d. records retained of the dates and results of the physical counts.

*Evidence - Reconciliation of client securities - Physically held client securities*

30. The main factors that will be considered are:
- a. detailed instructions for the counts;
  - b. an independent function (such as compliance department or internal audit) organizing, controlling or participating in carrying out the counts and reconciliations;
  - c. sufficient time and resources devoted to the counts and reconciliations;
  - d. full and clear documentation of the counts and reconciliations;
  - e. counts carried out at the frequency and with the time limits required by the rules;
  - f. adequate explanations for reconciling items; and
  - g. completion of reconciliations (i.e. all items explained).

*Control objectives - Reconciliation of client securities - Client securities held by a custodian*

31. The main factors that will be considered are:
- a. reconciliations for all custodians performed with at least the frequency and in the manner required by the rules and the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules;
  - b. timely clearance of reconciling items;
  - c. the reconciliations undertaken by a person who is not involved with the recording or movement of the assets, if the size of the regulated entity permits this segregation of duties; and
  - d. records retained of the dates and results of reconciliations including confirmations from external custodians.

*Evidence - Reconciliation of client securities - client securities held by a custodian*

32. The main factors that will be considered are:
- a. an independent function carrying out the reconciliations;
  - b. sufficient time and resources devoted to reconciliations;
  - c. full and clear documentation of the reconciliations;
  - d. reconciliations carried out at the frequency required by the rules;
  - e. adequate explanations for reconciling items; and
  - f. completion of reconciliations (i.e. all items explained).
33. Where client securities are physically held by the regulated entity itself, the auditor may attend part or all of one of the physical counts of client title documents. In reaching a conclusion regarding the extent to which this is necessary, the auditor considers the strength of controls surrounding, and the independence of, the count, reconciliation, day to day processing and custody of client documents of title.
34. The auditor examines confirmations from independent custodians of documents of title held by them.
35. The auditor inspects correspondence and agreements with custodians in order to verify compliance with the rules.
36. In larger regulated entities, a rolling reconciliation basis of confirming client title documents (similar to a manufacturing company's system of perpetual stock-taking) is sometimes adopted. Care must be taken to ensure that systems and controls are in place to prevent teeming and lading.

## **CLIENT MONEY**

### **Introduction**

37. The Client Money Rules apply to client money of a licensed corporation that is received or held by or on behalf of:

- a. the licensed corporation, in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or
- b. an associated entity of the licensed corporation where such an associated entity is not an authorized financial institution, in relation to such conduct of the regulated activity.

The Client Money Rules do not therefore apply to associated entities of registered institutions. The reference to "regulated entity" in this section below is therefore restricted to a licensed corporation or its associated entity that is not an authorized financial institution.

38. The Client Money Rules do not apply to client money of a licensed corporation that is received or held outside Hong Kong by the licensed corporation or an associated entity of the licensed corporation.
39. The Client Money Rules do not apply to client money of a licensed corporation that is in a bank account established and maintained by a client of the licensed corporation in that client's name.
40. For the particular regulated entity, the auditor needs to understand what may constitute client money that is covered by the Client Money Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client money, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Money Rules as a result.

#### **Segregated accounts**

41. When a regulated entity holds or expects to hold client money, it must open one or more segregated accounts, each of which shall be designated as a trust account or client account. These must be established and maintained with:
  - a. an authorized financial institution; or
  - b. any other institution approved by the SFC for the purposes of the Client Money Rules, either generally or in a particular case.

#### **Planning**

42. The auditor's work on client money will be planned in relation to the three reporting requirements. For client money, the main areas that need to be addressed by the auditor, to enable it to fulfil its reporting requirements are:
  - a. whether during the period under review, the regulated entity had systems of control in place that were adequate to ensure compliance with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules;
  - b. whether during the period under review, the regulated entity has complied with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules; and
  - c. whether during the period under review, the regulated entity has complied with section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client money.
43. The control objectives that the auditor would expect to see in a regulated entity holding client money and the evidence from which the auditor seeks to draw reasonable conclusions are outlined below. They are only indicative and will not be applicable to all regulated entities holding client money, especially smaller ones.



**Adequate systems of controls - Payment of client money into segregated accounts (section 4)**

44. Client money held by regulated entities has to be held on trust for clients in one or more segregated bank accounts designated as a trust account or client account.

**Control objectives - Payment of client money into segregated account**

45. The main factors that will be considered are:
- a. all client money is paid within one business day into a segregated account;
  - b. bank accounts opened only with an authorized financial institution, or any other institution approved by the SFC for the purposes of the Client Money Rules;
  - c. bank accounts include "Client Account" or "Trust Account" in their description in accordance with section 4(1) of the Client Money Rules;
  - d. appropriate statements, confirmations and agreements sent to and received from the authorized financial institutions;
  - e. systems are adequate to identify all client money;
  - f. systems are adequate to ensure that all client money and only client money is paid in compliance with the rules (other than where it is specifically allowed by the rules);
  - g. systems are adequate to ensure that all client money is paid in promptly; that is within one business day, unless otherwise disposed of in accordance with the rules; and
  - h. client money is only applied for the purposes of the client to whom it relates.

**Evidence - Payment of client money into segregated accounts**

46. The main factors that will be considered are:
- a. clear internal instructions setting out the procedures to be followed in dealing with any potential client money;
  - b. suitable levels of staff (i.e. with the appropriate training and experience) responsible for establishing segregated accounts and identifying client money within the regulated entity;
  - c. lodgements regularly and promptly made;
  - d. lodgements to segregated accounts comprise client money only, except as otherwise permitted;
  - e. lodgements to non client accounts do not include client money;
  - f. an up to date list of all bank accounts which identifies those that are segregated accounts; and
  - g. bank statements agreeing to the regulated entity's records.

**Adequate systems of controls - Payment of client money out of segregated accounts (section 5)**

**Control objectives - Payment of client money out of segregated accounts**

47. The main factors that will be considered are:
- a. systems are adequate to ensure that all client money withdrawals in Hong Kong are made in compliance with the rules; and
  - b. all withdrawals from segregated accounts are made only for prescribed purposes and in accordance with the rules.

**Evidence - Payment of client money out of segregated accounts**

48. The main factor that will be considered is:
- a. withdrawals are properly authorized and for purposes approved by the rules.

**Adequate systems of controls - Treatment of interest on client money held in segregated accounts (section 6)**

49. The Client Money Rules require that interest derived from client money is held in a segregated account. To the extent that any amount of interest retained in a segregated account which the regulated entity is entitled to retain under an agreement with the client(s), this would be paid out of the account within one business day after the interest is credited to the account or the regulated entity becomes aware that the interest has been credited to the account.

**Control objectives - Treatment of interest on client money held in segregated accounts**

50. The main factors that will be considered are:
- a. appropriate procedures in place for identifying and withdrawing regulated entity's entitlement of interest on segregated accounts on a timely basis;
  - b. where applicable, interest paid on all money subject to interest calculations; and
  - c. interest payments correctly calculated by reference to the appropriate dates.

**Evidence - Treatment of interest on client money held in segregated accounts**

51. The main factors that will be considered are:
- a. evidence that regulated entity's interest entitlements are withdrawn on a timely basis in accordance with the rules; and
  - b. schedules showing how interest due to clients has been calculated (or equivalent computer processes).

**Adequate systems of control - Timely renewal of standing authorities (section 8(4))**

**Control objectives - Timely renewal of standing authorities**

52. The main factors that will be considered are:
- a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;

- b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
- c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

**Evidence - Timely renewal of standing authorities**

53. The main factors that will be considered are:
- a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.

**Adequate systems of controls - Requirement to pay money other than client money out of segregated accounts (section 10)**

54. The Client Money Rules require that a regulated entity which becomes aware that it is holding an amount of money in a segregated account that is not client money of the regulated entity shall, within one business day of becoming so aware, pay that amount of money out of the segregated account.

**Control objectives - Requirement to pay money other than client money out of segregated accounts**

55. The main factor that will be considered is appropriate procedures in place for identifying and withdrawing regulated entity's money from segregated accounts on a timely basis.

**Evidence - Requirement to pay money other than client money out of segregated accounts**

56. The main factor that will be considered is evidence that regulated entity's money is withdrawn on a timely basis in accordance with the rules.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 11)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

57. The main factors that will be considered are:
- a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined by section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

58. The main factors that will be considered are:
- a. evidence that the regulated entity has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

**Compliance with the rules**

59. The work that the auditor will have performed as outlined above in relation to determining whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules is likely to also enable them to report on whether during the period under review, the regulated entity has complied with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules.

Depending on the results of the work on the systems of control, some additional testing is likely to be required to enable the auditor to issue its conclusion on the regulated entity's compliance with the rules during the period under review.

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

**Adequate accounting records have been maintained**

**Control objectives - Adequate accounting records have been maintained**

60. The main factors that will be considered are:
- a. proper recording of movements of client money;
  - b. interest credited in accordance with the rules;
  - c. reconciliations carried out in accordance with the rules; and
  - d. appropriate titles are given to accounts.

**Evidence - Adequate accounting records have been maintained**

61. The main factors that will be considered are:
- a. adequate details of the day to day entries of money paid into and out of the segregated accounts and individual client accounts including:
    - i. dates of receipts and payments;
    - ii. name of the client;
    - iii. name of the person from whom money was received or to whom it was paid, if other than the client;

- iv. sub-ledgers with individual client accounts; and
- v. evidence of designation from a client;
- b. records of the interest earned on the segregated accounts, the determination of the amount of interest payable to clients and the dates and amounts of interest paid/credited to clients;
- c. records maintained on a timely basis;
- d. evidence that reconciliations have been carried out as required and reconciling items have been investigated and cleared promptly (for more detailed guidance on reconciliations see paragraphs 62 to 67 below);
- e. the records maintained comply with the guidance given by the SFC;
- f. to provide third party evidence of client balances (except settlement balances), the auditor may consider obtaining direct confirmation from clients; in practice, this may be conveniently combined with testing the accuracy of statements of their securities sent to clients; and
- g. circularisation of account balances in accordance with paragraph 27 of this Appendix.

### **Reconciliations**

62. The requirement to carry out reconciliations is set out in the Keeping of Records Rules.
63. Regulated entities that hold client money are required to reconcile each month any differences during that month in its balances or positions with any of their associated entities and other parties, including:
- a. recognised exchange companies;
  - b. clearing houses;
  - c. other intermediaries;
  - d. custodians; and
  - e. banks,
- and show how such differences were resolved.

#### *Control objectives – Reconciliation*

64. The main factors that will be considered are:
- a. client/trust money per the segregated account, as recorded by the regulated entity, is reconciled with the total of balances recorded as due to each client at least each month;
  - b. balance of each such segregated account, as recorded by the regulated entity, is reconciled with the relevant bank statements;
  - c. the reconciliations are properly prepared and adequate explanations given for reconciling items, which would be cleared without delay; and
  - d. records are retained of the dates and results of the reconciliations.

*Evidence – Reconciliation*

65. The main factors that will be considered are:
- a. an up-to-date list of the segregated accounts held that agrees with the segregated accounts being reconciled;
  - b. evidence of an independent preparation and review of these reconciliations; and
  - c. reconciliations being carried out regularly over the period under review.
66. The auditor carries out normal audit tests on bank reconciliations. Particular attention will be paid to reconciling items, ensuring that outstanding and uncleared items are properly identified and are duly cleared shortly after the reconciliation. As part of its substantive testing, the auditor examines and where appropriate obtain direct confirmation of bank balances from each bank concerned.
67. The regulated entity would also reconcile its segregated bank accounts as often as necessary but at least once every month. Some regulated entities need to reconcile segregated accounts daily if the volume of business is high.

**NO CLIENT ASSETS**

68. The auditor must be alert to a situation where a licensed corporation is not permitted under its licensing condition to hold client assets or does not, as a matter of policy, hold client assets. Where this is the case, the licensed corporation would have systems in place to avoid receiving and holding client assets.
69. Although the auditor is not required to give the SFC independent assurance that the licensed corporation has not administered or held client assets, it still considers carrying out the following procedures:
- a. enquire as to what arrangements a licensed corporation has in place to ensure that relevant staff are aware of what constitutes client assets. This could be documented in a procedural manual or internal memorandum and would outline the procedures to be followed if client assets are identified;
  - b. enquire as to how settlements are effected on behalf of clients (reference will be made to client documentation and payment instructions on contract notes or statements);
  - c. review the cash book in order to confirm that receipts and payments in the cash book only relate to the licensed corporation's own money and that no client money is being received or held;
  - d. review the licensed corporation's client files to see whether they provide any indication that it has held client assets in order to undertake a particular transaction;
  - e. review client agreements for statements of how custody is to be operated; as a corollary, review the agreements with any custodians used and the counterparty files (i.e. the documentation which supports the securities transactions) for correspondence on settlement procedures to ensure that there is no evidence that the licensed corporation has offered client money protection (i.e. held separately in accordance with the rules);

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

- f. ascertain whether a system of review exists to ensure that client assets are not administered or held. This could constitute periodic review by the internal auditor or compliance officer and encompasses substantive review of the licensed corporation's bank accounts and client agreements; and
  - g. enquire as to details of any client money the licensed corporation has received and the action taken.
70. The auditor will consider obtaining written representations from management that the licensed corporation has not breached any rules relating to the client assets during the period under review.

Effective upon issue

*Practice Note 820*

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# **The Audit of Licensed Corporations and Associated Entities of Intermediaries**



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



**PRACTICE NOTE**  
**820**  
**THE AUDIT OF LICENSED CORPORATIONS AND**  
**ASSOCIATED ENTITIES OF INTERMEDIARIES**

*(Issued February 2004; revised September 2004 (name change), revised March 2008 and revised [ ] )*

<i>Contents</i>	<i>Paragraphs</i>
<b><u>PART I – GENERAL</u></b>	
Introduction	1 - 7
Definitions	8
Legislation and regulatory requirements	9 - 27
<b><u>PART II - THE AUDIT OF FINANCIAL STATEMENTS</u></b>	
Introduction	28
HKSA's	29 - 70
<b><u>PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES</u></b>	
Introduction	71
Management's responsibilities	72 - 75
Auditor's responsibilities	76 - 79
General guidance for fulfilling auditor's responsibilities	80- 83
Auditor's reporting requirements	84 - 89
Guidance on the reporting requirements of the Compliance report	90 – 114
<b><u>PART IV - OTHER REPORTING CONSIDERATIONS</u></b>	
Audit Questionnaire	115 - 117
Account Disclosure Document	118
Cessation of Activities	119 - 120
<b><u>PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION</u></b>	
Introduction	121 - 125
The auditor to lodge report with the SFC in certain cases	126 - 135
Other communications by the auditor	136 - 158
The auditor's duty of secrecy	159 - 164

**Communications by the SFC to the auditor under  
section 378(3)(h) of the SFO**

**165 – 167**

**APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS**

**APPENDIX 2 - CLIENT ASSETS**

**PRACTICE NOTE**  
**820**  
**THE AUDIT OF LICENSED CORPORATIONS AND**  
**ASSOCIATED ENTITIES OF INTERMEDIARIES**

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

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

**PART I - GENERAL**

**Introduction**

1. The purpose of this Practice Note is to assist the auditor to develop an approach to the audit of the financial statements of licensed corporations and associated entities of intermediaries. This is dealt with in Part II.
2. This Practice Note also provides guidance on the auditor's other reporting responsibilities under the Securities and Futures Ordinance (SFO) which are set out in the Securities and Futures (Accounts and Audit) Rules. This is dealt with in Part III.
3. Guidance on the completion of the Securities and Futures Commission's (SFC) Audit Questionnaire by the auditor is set out in Part IV.
4. The auditor is entitled under the SFO to report directly to the SFC in exceptional circumstances and, in some cases, has a duty to do so. Guidance on such ad hoc reporting is set out in Part V.
5. This Practice Note has been prepared in consultation with the SFC.
6. This Practice Note is based on the SFO in effect as at 1 April 2003, and the subsidiary legislation, codes and guidelines issued by the SFC up to 1 August 2007. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this Practice Note should be used in conjunction with the legislation.
7. It should be borne in mind that certain expressions used in the SFO may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this Practice Note, the auditor will wish to seek legal advice.

## Definitions

8. The definitions used in this Practice Note are:

a. *Associated entity*

A company that is in a controlling entity relationship with an intermediary and receives or holds in Hong Kong client assets of the intermediary.

b. *Client assets*

As defined in section 1 in Schedule 1 of the SFO.

c. *Client asset rules*

Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules.

d. *Codes and guidelines*

Codes and guidelines issued by the SFC under the SFO.

e. *FRR*

Securities and Futures (Financial Resources) Rules.

f. *Intermediary*

A licensed corporation or a registered institution.

g. *Internal Control Guidelines*

"Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission" issued by the SFC.

h. *Licensed corporation*

A corporation which is granted a licence by the SFC under Part V of the SFO for a regulated activity.

i. *Liquid assets*

Such assets as are prescribed in Division 3 of Part 4 of the FRR.

j. *Liquid capital*

The amount by which liquid assets exceeds ranking liabilities.

k. *Ranking liabilities*

The amounts required under Division 4 of Part 4 of the FRR.

l. *Registered institution*

An authorized financial institution registered under Part V of the SFO.

m. *Regulated activities*

Dealing in securities, dealing in futures contracts, leveraged foreign exchange trading, advising on securities, advising on futures contracts, advising on corporate finance, providing automated trading services, securities margin financing and asset management.

n. *Regulated entity*

A licensed corporation or an associated entity of an intermediary.

o. *Segregated account*

A segregated account established and maintained under section 4(1) and (2) of the Securities and Futures (Client Money) Rules or under section 5(1) and (2) of the Securities and Futures (Client Securities) Rules.

p. *SFC*

Securities and Futures Commission.

q. *SFO*

Securities and Futures Ordinance.

r. *Suggested Control Techniques*

"Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.

s. *Systems of control*

The internal controls over trading, accounting, settlement and stock holding systems that a licensed corporation or an associated entity has implemented to ensure its compliance with the SFO and any rules made under the SFO.

## Legislation and regulatory requirements

### The SFO

9. Under the licensing and registration regime of the SFO, any business entity which carries on or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by or registered with the SFC. It is a serious offence to act as an intermediary in Hong Kong without the appropriate licence or registration.
10. The SFC administers the regulation of the regulated activities and assumes the duties of front-line regulator of licensed corporations. It also applies certain requirements to associated entities of intermediaries in relation to their receipt and holding of client assets. The SFC is also responsible for all investigations and disciplinary matters under the SFO, subsidiary legislation, codes and guidelines.
11. Regulated entities must observe at all times all the provisions of the SFO, subsidiary legislation, codes and guidelines. In association with these requirements, regulated entities must file audited annual financial statements within four months of the financial year end to the SFC.
12. The SFO is designed to protect investors and, therefore, is concerned with ensuring that regulated activities in Hong Kong are conducted in accordance with the relevant regulations and rules by persons who are fit and proper and are licensed or registered to conduct such business.

13. The regulatory powers of the SFC are primarily vested in the SFO.
14. Section 5 of the SFO details the functions of the SFC. The functions pertinent to this Practice Note are as follows:
  - a. to take steps to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - b. to supervise, monitor and regulate activities carried on by regulated entities;
  - c. to promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on regulated activities;
  - d. to promote and develop an appropriate degree of self-regulation;
  - e. to take steps it considers appropriate to ensure relevant provisions are complied with;
  - f. to secure an appropriate degree of protection for members of the investing public investing in or holding financial products;
  - g. to promote, encourage and enforce the adoption of appropriate internal controls and risk management systems; and
  - h. to suppress illegal, dishonourable and improper practices in the industry.

*Regulated activities*

15. The SFO covers nine types of regulated activities:

Type 1: dealing in securities;

Type 2: dealing in futures contracts;

Type 3: leveraged foreign exchange trading;

Type 4: advising on securities;

Type 5: advising on futures contracts;

Type 6: advising on corporate finance;

Type 7: providing automated trading services;

Type 8: securities margin financing; and

Type 9: asset management.

*Auditor's statutory rights and duties*

16. Guidance on the auditor's statutory rights and duties under the SFO is given in Parts III and V below.

**Regulatory requirements**

17. The SFO provides a framework for the regulation of regulated entities in Hong Kong and the detailed requirements are set out in subsidiary legislation, codes or guidelines issued by the SFC. Each regulated entity is bound by all these requirements, where applicable, to remain fit and proper. The main provisions of the SFO, subsidiary legislation, codes or guidelines are set out in the following paragraphs but they are not a substitute for the legislation and rules themselves. In addition, the SFC has posted a series of "Frequently Asked Questions" on its website which provide a useful source of reference on how to interpret specific circumstances which may arise.

*Licensing and registration*

18. Persons carrying on business in a regulated activity in Hong Kong are required to have successfully applied for a licence, or a registration in the case of an authorized financial institution. In addition, they must remain fit and proper at all times.

*Business conduct*

19. This is the ongoing requirement expected of regulated entities in conducting their business and is designed to ensure that adequate standards are maintained in dealings with clients.
20. The requirements for business conduct are set out either in subsidiary legislation or in non-statutory codes of conduct. Breach of legislation is subject to criminal sanctions and breach of any codes of conduct may be taken into account in determining fitness and properness. The auditor has no requirement to express an opinion on the business conduct of a regulated entity but should be aware of the requirements.
21. The nine basic principles for business conduct cover the following areas:
- a. honesty and fairness;
  - b. diligence;
  - c. capabilities;
  - d. information about clients;
  - e. information for clients;
  - f. conflicts of interests;
  - g. compliance;
  - h. client assets; and
  - i. responsibility of senior management.

*Client assets*

22. The client asset rules apply to regulated entities that control or are otherwise responsible for client assets and they cover the proper protection of these assets. There are two sets of rules:
- a. one dealing with client securities; and
  - b. the other dealing with client money (not applicable to an associated entity of a registered institution or an associated entity of a licensed corporation where the associated entity is an authorized financial institution).
23. The Securities and Futures (Client Securities) Rules require client securities and securities collateral received or held in Hong Kong to be treated by regulated entities in a prescribed manner, such as depositing the securities in the safe custody of a segregated account. There are no prescribed rules for client securities received or held overseas.
24. The Securities and Futures (Client Money) Rules require segregation of client money received or held in Hong Kong by licensed corporations and their associated entities (unless they are authorized financial institutions) within the specified time limit. There are no prescribed rules for client money received or held overseas.

*Record keeping*

25. The Securities and Futures (Keeping of Records) Rules are rules for the keeping of accounts and records by regulated entities. Such records are required to contain sufficient details to explain business activities and operations and account for their client assets, and to be retained for a specified period of time.

*Financial resources requirements*

26. The FRR are made to ensure that licensed corporations are financially sound and have the resources to provide adequate services to investors.
27. Subject to exceptions, licensed corporations are subject to the paid-up capital and liquid capital requirements. The requirements are different for different regulated activities. However, where a corporation is licensed for more than one regulated activity, the highest of the paid-up share capital and liquid capital requirements which are applicable to the different regulated activities will apply.



## PART II - THE AUDIT OF FINANCIAL STATEMENTS

### Introduction

28. Hong Kong Standards on Auditing (HKSA) apply to the audit of the financial statements of any entity, irrespective of the size of the entity, its legal form, or the nature of its activities. The commentary which follows identifies the special considerations arising from the application of certain individual HKSA to the audit of the financial statements of regulated entities, and suggests ways in which these can be addressed. Where no special considerations arise in relation to a particular HKSA, no material is included. For the specific requirements of a HKSA, auditor would refer to the HKSA concerned.

### HKSA 210: AGREEING THE TERMS OF AUDIT ENGAGEMENTS

#### Background note

***The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (HKSA 210 paragraph 9)***

29. In addition to those principal contents set out in HKSA 210, the auditor's engagement letter would also cover reporting requirements under the Securities and Futures (Accounts and Audit) Rules and in particular, the auditor's rights and duties to report directly to the SFC. The engagement letter makes it clear that the statutory duty to report places an obligation on the auditor to report matters if found and does not involve undertaking additional work to identify them. It also clarifies that the auditor may sometimes consider it necessary to report directly to the SFC without the client's prior knowledge or consent.

### HKSA 240: THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

#### Background note

***In accordance with HKSA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. (HKSA 240 paragraph 25)***

30. In addition to the conditions or events specified in HKSA 240 as increasing the risk of fraud, the following factors may be especially relevant for regulated entities (this list is not exhaustive):
- a. backlogs in key reconciliations, particularly those with brokers and exchanges and for bank accounts and safe custody accounts - both the regulated entity's own and those relating to its clients;
  - b. inadequate segregation of duties between the front, middle and back office staff (i.e. "incompatible functions");
  - c. complex products and transactions inadequately understood by management;
  - d. inadequate definition of management responsibilities and supervision of staff;
  - e. elements of the remuneration package (particularly bonuses) for certain staff which are highly geared in relation to reported profits or revenues;
  - f. existence of hold mail arrangements, operation of discretionary accounts, and issuance and acceptance of third party or cash cheques;
  - g. volatility in the market place;

- h. no established compliance culture or inadequate internal controls; and
- i. risk of management override of controls.

Additional factors relevant for regulated entities can be found in the SFC's website which contain press releases and circulars providing examples of malpractices and advisory circulars of compliance areas.

31. Regulated entities are specifically required by the SFC to have adequate systems of internal control over client assets, which include appropriate systems to minimize the risk of losses to the business from irregularities, fraud or error. The auditor needs to bear in mind their responsibilities to report to the SFC in accordance with guidance set out in Part V below.

## **HKSA 250: CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

### **Background note**

***The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. (HKSA 250 paragraph 13)***

32. The auditor needs to recognize particularly that some laws and regulations are central to the regulated entity's ability to conduct its business as compliance is a prerequisite of obtaining a licence to operate. Non-compliance may reasonably be expected to result in the regulated entity ceasing operations, or call into question the regulated entity's status as a going concern.
33. The auditor of regulated entities will normally:
- a. discuss with the regulated entity's general counsel, compliance officer, internal auditor and other personnel responsible for compliance, and review any work on compliance matters carried out by them;
  - b. read the SFC's press releases and public register of licensed persons on its website for any disciplinary actions or licensing conditions imposed on the licensed corporation, its responsible officer or licensed representative;
  - c. review correspondence between the regulated entity and the SFC; and
  - d. assess the actual or contingent consequences arising from non-compliance and consider the impact on the financial statements.
34. If the auditor becomes aware of correspondence between the regulated entity and the SFC which are subject to the secrecy provisions of section 378 of the SFO, the auditor should request the regulated entity to seek the SFC's consent to disclosing the correspondence to the auditor. Paragraphs 165 to 167 provide additional information on the circumstances that the SFC may communicate to the auditor matters pertinent to a regulated entity for the purpose of enabling or assisting the SFC to perform its functions under any of the relevant provisions and paragraph 70b provides suggestions for additional representation to be obtained from management.

### **Money Laundering**

35. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which regulated entities operate. By the nature of their business, regulated entities may be ready targets of those engaged in money laundering activities.

36. The primary bodies of law in Hong Kong concerned with the subject of money laundering are the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance. Details on the matters are set out in the related guidance notes and circulars issued by the SFC. The HKICPA has issued in July 2006 a Legal Bulletin on “Requirements on Anti-money Laundering, Anti-terrorist Financing and Related matters”.
37. The SFC expects regulated entities to establish policies and controls to combat money laundering and terrorist financing which cover the following areas:
- a. the establishment and maintenance of policies, procedures and controls to deter and to recognize suspicious transactions;
  - b. the establishment of a procedure to report suspicious transactions;
  - c. evidence of client identification;
  - d. retention of client identification and transaction records for use as evidence in future investigations; and
  - e. education and training of staff.

**Codes and guidelines issued by the SFC**

38. The auditor has no direct reporting responsibility in respect of the codes and guidelines issued by the SFC. Nevertheless, breaches of such codes and guidelines may:
- a. give rise to claims by investors against the regulated entity; and
  - b. cause the regulated entity to have its business restricted or, in extreme cases, have its licence revoked so threatening its viability as a going concern.
39. The auditor will also be aware that breaches of the codes and guidelines could have consequences for other matters which are the subject of the auditor’s reporting responsibilities to the SFC for example, financial resources, accounting records and the handling of client assets.
40. The auditor would ensure that members of the audit team have a general understanding of the applicable codes and guidelines, sufficient to enable them to be alert to possible non-compliances which come to their attention.
41. As part of the normal procedures undertaken for the purposes of the audit of the financial statements and reporting under the Securities and Futures (Accounts and Audit) Rules, the auditor would gain an understanding of the regulated entity’s operations, including the nature of the business carried out. They would also obtain an understanding of the control environment that exists, including the regulated entity’s higher level procedures for complying with the applicable codes and guidelines.

42. Such an understanding will provide an indication of the extent to which the general atmosphere and controls in the regulated entities are conducive to compliance, for example through consideration of:
- a. the adequacy of procedures and training to inform staff of the requirements of the applicable codes and guidelines to ensure that they meet those requirements;
  - b. adequacy of authority and supervision;
  - c. the review of compliance by senior management;
  - d. procedures to ensure that possible non-compliances are investigated by an appropriate person and are brought to the attention of senior management; and
  - e. the authority of, and resources available to, the compliance officer, internal auditor and those in charge of compliance functions.
43. The auditor needs to be alert to any indication that a regulated entity is conducting business outside the scope of its licence as this may amount to an offence under the SFO.
44. Where an apparent non-compliance of the codes and guidelines comes to the auditor's attention, it needs to ensure that the implications for its reporting responsibilities are correctly identified.
45. The auditor would enquire of management and staff whether any non-compliances have occurred and obtain appropriate representations from management, preferably in writing, addressing any possible non-compliances which have come to their attention.
46. The auditor would also note that the Codes and Guidelines issued by the SFC are not exhaustive in nature and auditor would always exercise professional judgment in determining the adequacy of controls and certain behaviours/conduct.

## **HKSA 260: COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE HKSA 265: COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT**

### **Background note**

*The auditor shall communicate the following matters with those charged with governance:*

- *The auditor's responsibilities in relation to the financial statement audit (HKSA 260 paragraph 14);*
- *Planned scope and timing of the audit (HKSA 260 paragraph 15);*
- *Significant findings from the audit (HKSA 260 paragraph 16); and*
- *In the case of listed entities, auditor independence (HKSA 260 paragraph 17).*

*The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (HKSA 265 paragraph 9)*

47. The SFC may request copies of the auditor's management letters from regulated entities. Against this background, the auditor may consider it prudent to include in its report to directors or management, as a matter of course, a statement that:
- a. the management letter has been prepared for the sole use of the regulated entities;
  - b. it must not be disclosed to a third party (except to the SFC), or quoted or referred to, without the written consent of the auditor; and

- c. no responsibility is assumed by the auditor to any other person.

**Breach of laws and rules issued by the SFC**

48. Unless there are reasons for supposing a report would be made directly to the SFC (see Part V below), the auditor would discuss promptly with appropriate management of the regulated entity (including the compliance officer) apparent breaches of the law, codes and guidelines, or instances where a regulated entity may be carrying on activities outside the scope of its authorization, which come to their attention in the course of the audit. This will both enable the auditor to determine the impact of the matter on its reporting obligations, and permit appropriate corrective action to be taken by management.
49. Breaches or possible breaches of the law, codes and guidelines which come to the auditor's attention and which neither require the auditor to make a report to the SFC under the statutory duty provisions of the SFO, nor require its auditor's report to be qualified, will be considered for inclusion in the auditor's management letter.

**HKSA 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS**

**HKSA 315: IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

**Background note**

*The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. (HKSA 300 paragraph 7)*

*The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (HKSA 315 paragraph 5)*

*Risk assessment procedures are defined as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. (HKSA 315 paragraph 4.(d))*

50. Regulated entities can be complex and the auditor would seek to understand the business and the regulatory regime in which they operate. The auditor would ensure that the audit engagement is performed/overseen by staff with sufficient knowledge about the licensed corporation's operations, market practices, the products handled by the licensed corporation and the SFC regulations for regulated activities carried out by the licensed corporation. A fundamental principle embodied in the HKICPA Code of Ethics for Professional Accountants is that the auditor does not accept or perform work which it is not competent to undertake. The auditor may also consider the use of technical specialists, for example where the business is trading in complex products or is heavily reliant on e-commerce. Generally, there is a close relationship between planning and understanding the entity and an understanding of the high level control environment.
51. To avoid potential duplication of audit effort, the audit approach to a regulated entity normally addresses the audit of the financial statements and the work required for reporting under the Securities and Futures (Accounts and Audit) Rules together. The auditor plans so as to ensure that its audit work on the financial statements and the regulatory reporting is completed within timescales imposed by the SFC. The audit plan for a regulated entity typically explains the legal and regulatory background and, in order to reduce audit risk, discusses those areas where the auditor's responsibilities are different from those for other types of entity.

### **Direct communication from the SFC**

52. As explained in paragraph 165 below, the SFC is able to disclose information directly to the auditor. Where such a matter has been brought to the attention of the auditor, it considers the implications for its work and may amend its approach accordingly. However, the fact that it may have been informed of such a matter by the SFC does not, of itself, require the auditor to change the scope of its work, nor does it require the auditor actively to search for evidence in relation to the matter communicated by the SFC.
53. The auditor has no obligation to seek out breaches of the law, codes and guidelines. However, the auditor would include procedures within their planning process to ensure that members of the audit team are able to recognize reportable matters which are likely to be encountered in their audit work and that such matters are reported to the audit partner without delay.

### **Internal controls and risk assessment**

54. There is a wide variation between different regulated entities in terms of size, activity and organization, so that there can be no standard approach to internal controls and risk. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. In addition to the factors set out in paragraphs A17 to A41 and Appendix 1 of HKSA 315, the following factors would be considered by the auditor in assessing whether there may be an increased level of inherent risk of material misstatement:
- a. the nature and status of the regulated entities and any changes in their status which may affect the application of protection of clients' assets requirements;
  - b. a change in the market environment (for example, high volatility);
  - c. the introduction of new clients or products or marketing and distribution methods (for example e-commerce);
  - d. claims made in promotional literature (for example in relation to risks and performance);
  - e. the risk profile of business undertaken;
  - f. client profile (retail vs. institutional);
  - g. existence of claims and complaints by clients;
  - h. the complexity of products;
  - i. the consistency of products, methods and operations in different departments or locations;
  - j. the legal and operational structure of the regulated entities;
  - k. where a group structure exists, the financial and managerial support provided to and by other group companies;
  - l. the number of branches or sales offices (see paragraph 57 below);
  - m. the use of licensed representatives;
  - n. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
  - o. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;
  - p. the recruitment, competence, training and supervision of personnel; and

- q. the integrity, competence and experience of management.
55. Regulated entities vary greatly in the complexity of their operations and hence in the reliance which the auditor places on their detailed internal controls. These are particularly important in cases where the accounting system is at risk of failing to capture transactions which do not involve the immediate movement of funds - such as trading in certain derivative instruments or underwriting. A sound understanding of the process is required in order to guard against the risk of unrecorded or mis-recorded transactions. These may or may not be unauthorized but will also expose the regulated entity to possible loss, through failure to appreciate the risks which are actually being run.
56. Client assets is one area where detailed internal controls are particularly relevant. Client assets are an important and relevant factor to audit planning and any material deficiency in the adequacy of internal controls over client assets will need to be reported in the Compliance Report (see paragraphs 107 to 110). Any shortfall in client assets, whether due to misappropriation or otherwise, may have significant implications on the licensed corporation's compliance with the client asset rules and the adequacy of its internal controls. Furthermore, such shortfall could also impact on the financial position of the licensed corporation. Such implications and impact could affect the opinions to be given by the auditor in its audit report and compliance report and trigger the auditor's obligation to report to the SFC under section 157 of the SFO. If the auditor considers that the licensed corporation's system of control over client assets are inadequate or decides that no reliance would be placed on the licensed corporation's systems, the auditor would use its professional judgment to consider the use of fund tracing procedures or external circularisation as a substantive procedure to obtain evidence on some of the control objectives, e.g. paragraphs 45 and 47 of Appendix 2. Fund tracing means obtaining copies of sampled outward cheques issued by the licensed corporation from the bank or copies of cheques deposited into the bank account of the licensed corporation and verifying the identity of the payee or drawer against the licensed corporation's accounting records.
57. Some regulated entities operate a network of branches. In such instances, the auditor determines the degree of head office control over the business and accounting functions at the branch office and the scope and effectiveness of the regulated entity's inspection and/or internal audit visits. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the regulated entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to audit planning.
58. The auditor would consider how a computer information system (CIS) environment affects the audit. Computer information system (CIS) is integral to the business of a regulated entity due to the high volume of transactions and the linkages to various third party systems. Many regulated entities also use their CIS to prepare regulatory reports to the SFC. It is therefore common for the auditor to require a detailed knowledge of the regulated entity's CIS.
59. As new CIS technologies emerge, they are frequently employed by regulated entities to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of CIS and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

## HKSA 320: MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

### Background note

*When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. (HKSA 320 paragraph 10)*

*The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (HKSA 320 paragraph 11)*

*For purposes of the HKSAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. (HKSA 320 paragraph 9)*

60. The assessments of materiality and performance materiality for the financial statements of a Licensed Corporation will require an auditor to make the same professional judgment decisions as on any audit with reference to the Standard. However the auditor would remember that in respect of the Compliance Report there is no materiality concept outlined in the Securities and Futures (Accounts and Audit) Rules and therefore if the auditor becomes aware of any breach in the relevant Rules then that breach needs to be reported in the Compliance Report. The Audit Questionnaire that the auditor is asked to complete for submission to the SFC does however refer to whether the auditor has found any material breaches between the FRR submitted and the financial statements and therefore it is possible to have a reconciliation reported in the Compliance Report in respect of immaterial discrepancies between the submitted FRR and the financial statements but not to report this matter in the Audit Questionnaire if it is deemed to be immaterial.

## HKSA 402: AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANIZATION

### Background note

*The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. (HKSA 402 paragraph 11)*

61. Some regulated entities outsource a variety of activities. Specific examples include:
- a. safe custody of client assets by a custodian;
  - b. settlement or clearing of trades (this may or may not include the third party taking on the settlement risk, maintaining accounting records, reconciling client assets, sending client statements directly);
  - c. maintenance of accounting records;
  - d. product administration (such as unit trusts or savings schemes);
  - e. investment management; and
  - f. valuation of investments.



62. A regulated entity would ensure compliance with the law, codes and guidelines whether or not activities are outsourced. In addition, a regulated entity using a service organization would comply with the following requirements in respect of the outsourced activities:
- a. ongoing assessment and monitoring of the competence and independence of the third party including reviewing of reports issued in accordance with Practice Note 860.2 "Reports on internal controls of investment custodians made available to third parties" or Hong Kong Standard on Assurance Engagements 3402 "Assurance Reports on Controls at a Service Organization" or other relevant service provider reports;
  - b. responsibility for keeping records; and
  - c. responsibility for acts or omissions by the third party.

## HKSA 505: EXTERNAL CONFIRMATIONS

### Background note

***The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. (HKSA 505 paragraph 16)***

63. External confirmation of client account balances can provide strong evidence regarding the existence of the account at a certain date. It can also provide strong audit evidence regarding the operation of cut-off procedures.
64. For efficiency purpose, the auditor may circularize external confirmations of client account balances together with client assets held for custody so as to obtain audit evidence to support the financial statement assertions and regulatory reporting items at the same time. Further details on circularisation are set out in paragraph 27 of Appendix 2 to this Practice Note.
65. In determining the auditor's assessment of risk, consideration as to whether or not to perform external circularisation would also be linked to the fraud assessment (HKSA 240) and the assessment of the quality of internal controls, particularly over client assets (HKSA 315). The higher the auditor's assessment of risk, the more important it is for the auditor to seek reliable and relevant audit evidence from substantive procedures. For example, if the auditor considers that the licensed corporation has inadequate systems of control over client assets, or the auditor decides not to rely on the licensed corporation's internal control systems, then external confirmations of client account balances and client assets held by the licensed corporation would be a strong substantive audit procedure. In addition, the auditor may find it effective to supplement such external confirmations with a questionnaire to obtain corroborative information on the licensed corporation's compliance with aspects of the legislation and rules that the auditor also has responsibility to verify e.g. standing authorities.

## HKSA 560: SUBSEQUENT EVENTS

### Background note

***Subsequent events are defined as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. (HKSA 560 paragraph 5(e))***

***The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (HKSA 560 paragraph 6)***

***The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:***

- a. Discuss the matter with management and, where appropriate, those charged with governance.***
- b. Determine whether the financial statements need amendment and, if so,***
- c. Inquire how management intends to address the matter in the financial statements.***

***(HKSA 560 paragraph 10)***

66. In addition to the specific procedures to identify subsequent events which may require amendment to, or disclosure in the financial statements outlined in paragraph 7 of HKSA 560, for the regulated entity, the auditor would review correspondence with the SFC since the period end and make enquiries of management to determine whether any breaches of the law, codes and guidelines or other regulatory concerns have come to light since the period end.

## **HKSA 570: GOING CONCERN**

### **Background note**

***The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (HKSA 570 paragraph 11)***

67. In reviewing going concern, the auditor of a regulated entity would consider the following areas in addition to those set out in paragraph A2 of HKSA 570, since the possible regulatory action of the SFC on the regulated entity is particularly relevant to the going concern assumption:
- a. regulatory censure or fines;
  - b. regulatory capital shortages;
  - c. visits from the SFC;
  - d. reputation and other indicators (including client complaints);
  - e. general non-compliance with the law, codes and guidelines; and
  - f. unusual movements in the financial market.
68. If the auditor has any doubts as to the ability of a regulated entity to continue as a going concern, it may be required to make a report to the SFC under their statutory duties on which guidance is set out in Part V below.
69. If the auditor is performing a cessation audit as discussed in paragraphs 119 and 120, the auditor may wish to consider whether the financial statements of that entity should be prepared on a going concern or a break-up basis.

## HKSA 580: WRITTEN REPRESENTATIONS

### Background note

***The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (HKSA 580 paragraph 9)***

70. In addition to the examples of representations given in HKAS 580, the auditor of a regulated entity would also consider obtaining additional confirmations. The letter could cover inter alia the following representations:

- a. acknowledging management's responsibility for establishing and maintaining accounting records and systems of control in accordance with the law, codes and guidelines;
- b. confirming that management has made available to the auditor all correspondence and notes of meetings with the SFC (except for correspondence subject to section 378 of the SFO where no consent has been given by the SFC for the licensed corporation to disclose such correspondence to the auditor, if applicable) during and related to the relevant reporting period and up to the date of the auditor's report;
- c. that all complaints have been drawn to the attention of the auditor;
- d. where applicable, representation that no client money or client securities were administered or held by the regulated entity; and
- e. that the requirements under the Securities and Futures (Keeping of Records) Rules, the client asset rules and the FRR have been complied with.

## **PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES**

### **Introduction**

71. This Part of the Practice Note is intended to provide a common approach to reporting by the auditor on regulated entities and to establish clear unequivocal wording of the auditor's reports such that a standard form of wording may be used by the auditor when reporting. One benefit of establishing a standard form of report is that it removes any ambiguity as to the assurance obtained from the auditor about compliance with the requirements of the SFO. Example auditor's reports are set out in Appendix 1 to this Practice Note.

### **Management's responsibilities**

72. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules addresses matters for which the primary responsibility lies with the management of the regulated entity. The primary responsibilities of management under the Securities and Futures (Accounts and Audit) Rules are, broadly:
- a. to prepare annual financial statements in accordance with generally accepted accounting principles;
  - b. to prepare the applicable returns as detailed in section 3(1)(b) or 3(2)(b) (as the case may be) of the Securities and Futures (Accounts and Audit) Rules;
  - c. to prepare an Account Disclosure Document which sets out additional financial information (for Licensed Corporations only);
  - d. to prepare Analysis of Client Assets (for Associated Entity only);
  - e. to ensure that the client asset rules and the Securities and Futures (Keeping of Records) Rules are observed; and
  - f. to prepare the Business and Risk Management Questionnaire.

Details are set out in section 3 of the Securities and Futures (Accounts and Audit) Rules.

73. Management should consider the above in their design and maintenance of the systems of control. They should also recognize where appropriate the cost of a particular control, as against its purpose and expected benefit.
74. For the foregoing reasons, different systems and controls may be deemed adequate in different regulated entities, if they provide reasonable assurance that certain control objectives have been achieved. In designing the systems and controls, management would address inter alia the following general control objectives:
- a. the business is planned and conducted in an orderly, prudent and cost-effective manner in adherence to established and documented policies;
  - b. transactions and commitments are entered into only in accordance with management's general or specific authority;
  - c. client assets are safeguarded and are completely and accurately recorded;
  - d. the assets are safeguarded and the liabilities controlled;

- e. the risk of loss from fraud, other irregularities and error is minimized, and any such losses are promptly and readily identified;
  - f. management is able to monitor on a regular and timely basis the regulated entity's business's position relative to its risk exposure;
  - g. management is able to prepare complete and accurate returns for the SFC on a timely basis in accordance with the FRR; and
  - h. issues relating to compliance with the law, codes and guidelines are resolved in a timely manner to the satisfaction of the SFC.
75. In designing a control system, management needs to understand the interaction between manual and computer controls and how they contribute in aggregate to the achievement of the control objectives.

### **Auditor's responsibilities**

76. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules is primarily to provide assurance to the SFC on the financial information provided by the regulated entity and on the systems of control operated by the regulated entity during the financial year covered by the report in relation to the regulated entity's stewardship of client assets.
77. The precise matters on which the auditor is required to report vary according to the nature of the regulated entity's activities. Under section 4(1) of the Securities and Futures (Accounts and Audit) Rules, the auditor is required to report on the matters covered in paragraphs 78 and 79 below. The auditor will prepare an audit report on the regulated entity's financial statements and a compliance report, which is addressed to the board of directors of the regulated entity.
78. In the auditor's report on financial statements, the auditor should give an opinion:
- a. whether the financial statements give a true and fair view; and
  - b. whether the financial statements are in accordance with the records kept by the regulated entity under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules.
79. In the auditor's Compliance Report to management, the auditor should cover:
- a. in the case of a licensed corporation, whether the required returns made up to the last day of the financial year as detailed in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules have been correctly compiled from the records of the licensed corporation or, if not correctly compiled, the nature and extent of the incorrectness;
  - b. in so far as applicable, whether the regulated entity had systems of control in place that were adequate to ensure compliance with the SFC's requirements with regard to client assets during the financial year in question;
  - c. in so far as applicable, whether the regulated entity complied with the Securities and Futures (Keeping of Records) Rules and the client asset rules during the financial year in question; and
  - d. in the case of a licensed corporation, whether there appears to have been any contravention of the FRR by the licensed corporation during the financial year in question.

## General guidance for fulfilling auditor's responsibilities

80. In discharging its reporting responsibilities regarding a regulated entity, the auditor must have particular regard to any changes in the SFO and its subsidiary legislation and any other requirements of the SFC in force during the financial year to which the report relates.
81. The nature of the business undertaken by a regulated entity, its size and its particular circumstances will affect the nature and extent of the auditor's work. When planning its work, the auditor assesses the risks associated with the nature of the particular regulated entity. Certain risks will not be applicable to all regulated entities.
82. Other factors that will be considered are:
  - a. the scope of licensing in relation to the holding of client assets;
  - b. the extent of investment management discretion permitted;
  - c. the introduction of new and revised requirements, with reference to the up-to-date Q and A sections on the SFC website;
  - d. changes to existing requirements; and
  - e. modifications or waivers granted or special conditions imposed by the SFC.
83. In making an assessment of various risk factors, the auditor would normally meet senior management and the Compliance Officer as part of its planning process. It would also consider the following:
  - a. operational manuals;
  - b. documentation of systems and controls;
  - c. compliance monitoring programmes and results;
  - d. the records maintained by the regulated entity of any non-compliances and notifications to the SFC that may have occurred during the period under review;
  - e. correspondence with the SFC, relating to financial returns and any other matters;
  - f. the results of inspection visits made by the SFC;
  - g. the register of complaints received from clients during the period under review;
  - h. any relevant internal audit reports; and
  - i. any unresolved items from previously issued management letters on internal control weakness.

## Auditor's reporting requirements

84. The two separate reports mentioned in paragraph 77 above are required to be prepared by the auditor in respect of the year under review. They are required to be submitted by the regulated entities to the SFC within four months of their year end. The auditor should take all reasonable steps for its reports to be issued in order for the regulated entities to submit them to the SFC by the specified date.

### **The auditor's report on the financial statements**

85. For a regulated entity which is a Hong Kong incorporated company, the auditor's report contains an audit opinion expressed in true and fair terms pursuant to the Companies Ordinance requirements. It also states whether the financial statements are in accordance with the records kept under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules. An example auditor's report is given in Example 1 of Appendix 1 to this Practice Note.
86. Guidance on the detailed requirements of the Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules, which are also applicable to the auditor's report are set out in paragraphs 90 to 101 below.

### **Compliance Report by the auditor**

87. The Compliance Report setting out the auditor's conclusions on matters set out in paragraph 79 should be addressed to the directors of the regulated entity:
- a. For a licensed corporation, an example Compliance Report is given in Example 2 of Appendix 1 to this Practice Note.
  - b. For an associated entity of an intermediary, an example Compliance Report is given in Example 3 of Appendix 1 to this Practice Note.

#### *The assurance standards followed*

88. The auditor would state that it has conducted its Compliance Reporting engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 *Assurance Engagements Other Audits or Reviews of Historical Financial Information* issued by the HKICPA, and with reference to this Practice Note. It also states that it has carried out such procedures as were considered necessary for its report.

#### *The date of the report*

89. It is highly desirable that the Compliance Report is dated with the same date as the auditor's report on the financial statements.

### **Guidance on the reporting requirements of the Compliance report**

#### ***Internal control considerations relating to Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules***

90. In considering the adequacy of systems of control required by the client asset rules and the Securities and Futures (Keeping of Records) Rules, the auditor must recognize the inherent limitations of such systems. These limitations mean that, despite the existence of controls, errors or irregularities may occur and may not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or the risk that the degree of compliance with those procedures may deteriorate.
91. The auditor is required to report whether the regulated entity has satisfied the requirements of the Securities and Futures (Keeping of Records) Rules during the period under review. In order to report on whether the regulated entity has satisfied the requirements of these rules it is envisaged that consideration will be given to whether adequate systems for control of the regulated entity's accounting systems have been maintained.

92. The Securities and Futures (Keeping of Records) Rules set out the basic characteristics of adequate accounting records in general and include some guidance on the contents of specialized accounting records, especially those concerned with client assets. Management, in establishing and maintaining accounting records, and the auditor, in forming a view as to whether adequate records have been kept, will need to refer to the detailed rules relevant to the particular regulated activities.
93. The Securities and Futures (Keeping of Records) Rules require that regulated entities shall in relation to the businesses which constitute any regulated activities for which they are licensed and their associated entities as regards the receipt or holding of client assets in relation to such regulated activities, to keep, where applicable, such accounting, trading and other records as are sufficient to:

*a licensed corporation*

- a. explain, and reflect the financial position and operation of, such businesses;
- b. enable profit and loss accounts and balance sheets<sup>1</sup> that give a true and fair view of its financial affairs to be prepared from time to time;
- c. account for all client assets that it receives or holds;
- d. enable all movements of such client assets to be traced through its accounting systems and, where applicable, stock holding systems;
- e. reconcile, on a monthly basis, any differences in its balances or positions with other persons and show how such differences were resolved;
- f. demonstrate compliance with certain sections of the client asset rules and that it has systems of control in place to ensure such compliance;
- g. enable it readily to establish whether it has complied with the FRR; and
- h. keep records specified in the Schedule to and sections 5, 6, 7(2) or 8 of the Securities and Futures (Keeping of Records) Rules.

*an associated entity*

- a. account for the client assets;
- b. enable all movements of the client assets to be traced through its accounting systems and, where applicable, stock holding systems;
- c. show separately and account for all receipts, payments, deliveries and other uses or applications of the client assets effected by it, or on its behalf, and on whose behalf such receipts, payments, deliveries or other uses or applications of the client assets have been effected;
- d. reconcile, on a monthly basis, any differences in its balances or positions with other persons and show how such differences were resolved;
- e. demonstrate compliance with certain sections of the client asset rules and that it has systems of control in place to ensure such compliance; and
- f. keep certain specific records where applicable.

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<sup>1</sup> Different terms like income statement, statement of comprehensive income, statement of financial position, etc may be used in the auditor's report as long as they are consistent with the titles of the corresponding statements.



94. These records would be kept in such a manner as will enable an audit to be conveniently and properly carried out, and make entries in these records in accordance with generally accepted accounting principles where applicable. There are also particular requirements, over and above those outlined above, for licensed corporations involved in certain regulated activities.
95. Detailed guidance on the control objectives and audit evidence in relation to the auditor's reporting requirements with regard to client assets under the Securities and Futures (Accounts and Audit) Rules are included in Appendix 2 to this Practice Note. The auditor will need to apply judgment in determining the extent and nature of its work which would be based on a good understanding of the regulated entity's systems of control.
96. Underlying any systems of control adopted by a regulated entity is the control environment. Such an environment is created by management having and showing a positive attitude towards the operation of controls and by an organizational framework which enables proper segregation and delegation of control functions and which encourages failings to be reported and corrected. Thus, where a lapse in the operation of a control is treated as a matter of concern, rather than being largely overlooked, the control environment will be stronger and will contribute to effective systems of control; whereas a weak control environment will undermine detailed controls, however well designed.
97. Within this control environment, the control procedures needed to ensure that the business is conducted to protect investors' interests would be commensurate with the regulated entity's needs and particular circumstances, and also with the inherent risks of the business undertaken. The size of the regulated entity will have an important bearing on the design and formality of the systems and controls. The operating procedures and methods of recording and processing transactions used by small regulated entities often differ significantly from those of large regulated entities. Internal controls which would be relevant to a large regulated entity, may not be practical or appropriate in a small one. Management of a small regulated entity has less need to depend on formal controls for the reliability of the records and other information, because of personal contact with, or involvement in, the operation of the business itself. Nevertheless the need for a positive attitude to the control environment is equally relevant in both small and large regulated entities.
98. Regulated entities frequently have a high degree of computerization. While the control objectives described above apply in both a manual and a computerized environment, there are nevertheless certain requirements of an internal control system peculiar to a computerized environment.
99. Clearly, the emphasis between the two forms of control will be dependent not only on the degree of computerization but also on the circumstances and particular risks of the regulated entity. The greater the degree of computerization, the greater the emphasis that will need to be placed on the general and application controls of the computerized function, as part of the overall systems of internal control. However, the routine processing of a computerized system is generally more reliable than that of a manual system.
100. Systems of control, including the assignment of responsibilities as set out in the Internal Control Guidelines, need to be clearly documented if they are to be understood, communicated and operated effectively and consistently. Regulated entities and their auditor would consider whether appropriate documentation is a prerequisite of an adequate system.
101. The effective operation of a control system may be enhanced by an internal audit department or by specific monitoring performed by a compliance department. The existence of such departments and their scope and objectives are matters for management. In assessing the effectiveness of such departments, the auditor will consider the terms of reference of the departments, their independence from operational personnel and management, the quality of staffing and to whom they report in the regulated entity.

***Securities and Futures (Financial Resources) Rules***

102. Licensed corporations are required to submit to the SFC the following financial returns as referred to in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules made up to the last day of the financial year<sup>2</sup>:
- a. liquid capital computation (Form 1);
  - b. required liquid capital computation (Form 2);
  - c. summary of bank loans, advances and other credit facilities (Form 3);
  - d. Analysis of margin clients (Form 4);
  - e. Analysis of collateral received from margin clients (Form 5);
  - f. Analysis of rolling balance cash clients (Form 6);
  - g. Analysis of client assets (Form 8); and
  - h. Analysis of proprietary derivative positions (Form 10).

There is a requirement in the Compliance Report to state that the auditor is not aware of the licensed corporation not complying with the FRR throughout the year. If the licensed corporation has a very low excess liquid capital or is prone to material computational or classification errors this may lead to the auditor deciding to review and test a larger sample of FRR throughout the year. Those material errors may also need to be reported as a breach.

103. The auditor is required to give an opinion as to whether the financial returns referred to in paragraph 102 which have been submitted to the SFC have been correctly compiled from the records of the licensed corporation, or if not correctly compiled, the nature and extent of the incorrectness. This involves the auditor in examining the licensed corporation's compilations by reference to the FRR, paying particular attention to those areas most susceptible to management's discretion and having regard to the concept of prudence. Particular care will be exercised in cases where the licensed corporation is operating at a level close to the minimum requirement, since any shortfall (however small) is a contravention of the FRR and results in a higher possibility of window dressing. The auditor would note that the Securities and Futures (Accounts and Audit) Rules do not provide that immaterial discrepancies or reclassifications can be disregarded. Accordingly, the auditor qualifies its opinion where discrepancies and reclassifications are identified in the financial returns regardless of materiality.
104. If the auditor qualifies its Compliance Report in respect of the financial returns, the auditor either provides the reconciliations or explains the differences. The reconciliations or explained differences are attached to the Compliance Report.
105. In particular the auditor would check that the reconciliation agrees back to supporting documentation and that the explanations given for any reconciling items are reasonable. Reconciling items commonly relate to audit adjustments made after submission of the financial return.
106. It is common for a licensed corporation to submit a revised FRR return if errors are noted following the original submission in order to avoid a qualified Compliance Report attaching a reconciliation. An auditor should ensure that he identifies clearly the FRR he is commenting on in his Compliance Report and this should be the latest FRR submitted to the SFC prior to the date of the Compliance Report.

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<sup>2</sup> See Paragraph 106 for the exceptions.

***Securities and Futures (Client Securities) Rules and (Client Money) Rules***

107. There are essentially two aspects to the auditor's reporting responsibilities for client assets:
- a. whether during the period under review, the regulated entity had systems of control in place that were adequate to enable compliance with the relevant sections of the client asset rules; and
  - b. whether during the period under review, the regulated entity complied with the relevant sections of the client asset rules.
108. Guidance on the control objectives and audit evidence is set out in Appendix 2 to this Practice Note. The auditor applies judgment in determining the extent and nature of its work which is based on the following general requirements:
- a. the auditor understands the business of the regulated entity and the environment in which the regulated entity operates;
  - b. the auditor reviews the regulated entity's systems and consider whether these are adequate for control and accounting purposes, and are in accordance with the requirements set out in the Suggested Control Techniques; and
  - c. the auditor tests those systems and controls to establish that they are operating effectively.
109. When planning and carrying out its work, the auditor must always keep in mind the need for audit evidence in relation to the existence of client assets and the accuracy of the regulated entity's records.
110. Certain licensed corporations do not receive or hold client money or client securities either by choice or by limitation of their licensing condition. It would therefore not normally be necessary for the auditor to make reference to the client asset rules in the Compliance Report. However, the auditor would ensure that such licensed corporations have procedures in place to avoid receipt or holding of client assets. If during the course of the performance of these procedures (as set out in paragraphs 68 - 70 of Appendix 2 to this Practice Note) it comes to the auditor's attention that the licensed corporation has held client assets, it would be necessary for the auditor to make reference to the licensed corporation's compliance with the client asset rules in the Compliance Report. In these circumstances, the auditor will need to revisit the requirements under HKSA 250 and paragraphs 41 and 42 of this Practice Note.

***Qualified Compliance reports***

111. The auditor may qualify its Compliance Report on grounds other than those which arise in reporting on whether the financial statements give a true and fair view. Where the requirements of the rules upon which the auditor must report have not been met, its report includes a statement specifying the relevant requirements and the respect in which they have not been met, in sufficient detail for the breach or shortcoming to be clearly understood and evaluated. In particular, where the breach relates to a specific rule, the rule number or reference will be stated in the report.
112. In considering any matter indicating a possible breach of the FRR, client asset rules and the Securities and Futures (Keeping of Records) Rules or inadequate systems of control over client assets, the auditor analyzes the circumstances in order to identify its cause, and establish the action management has taken or intends to take to correct the matter.
113. If the auditor proposes to include any qualification or adverse statement in the Compliance Report (or its report on the financial statements), it is required under section 157(1)(b) of the SFO, as soon as reasonably practicable after it first proposes the inclusion of the qualification or adverse statement, to lodge with the SFC a report. Details are set out in Part V below.

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

114. The Securities and Futures (Accounts and Audit) Rules do not provide that trivial breaches can be disregarded. Where small exceptions are discovered, the auditor will need to qualify its opinion, although references can be made to the extent of the breach.

## **PART IV - OTHER REPORTING CONSIDERATIONS**

### **Audit Questionnaire**

115. In order to assist the SFC to carry out its functions of supervising licensed corporations, the auditor would normally on a voluntary basis complete an Audit Questionnaire for submission to the SFC, providing information in relation to the completed audit that is not readily available from the audited financial statements.
116. Section 158 of the SFO allows the auditor to provide such information to the SFC without the breaching of any duty of confidentiality to the licensed corporations.
117. The auditor would complete the Audit Questionnaire based on information obtained during the course of its audit of the financial statements covered by the Audit Questionnaire. The SFC does not expect the auditor to extend the scope of its work in order to complete the Audit Questionnaire.

### **Account Disclosure Document**

118. The SFC has issued the Account Disclosure Document for Licensed Corporation which sets out additional financial information to be disclosed by licensed corporations. In the Audit Questionnaire the auditor is requested by the SFC to state whether the auditor is satisfied that no material inconsistency between the audited financial statements and the additional disclosure of financial information as required by the Account Disclosure Document for Licensed Corporation came to its attention. If the auditor is aware of any material inconsistencies, the auditor states details of such inconsistencies in the Audit Questionnaire.

### **Cessation of Activities**

119. Where a licensed corporation ceases to carry on all of the regulated activities for which it is licensed, or where an associated entity of an intermediary ceases to be such an associated entity, they are required to submit to the SFC certain documents, including the audited financial statements made up to the date of cessation together with the corresponding auditor reports.
120. The responsibilities of the auditor and the reporting requirements in those audits are generally the same as those discussed in "Part III – Auditor's Reports under the Securities and Futures (Accounts and Audit) Rules".

## **PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION**

### **Introduction**

121. This Part of the Practice Note is concerned with communications:

- a. by the auditor to the SFC under the obligations established in section 157 of the SFO;
- b. by the auditor to the SFC under the protection of section 158 of the SFO; and
- c. by the SFC to the auditor under section 378(3)(h) of the SFO.

It is also concerned with the related issue of auditor's duty of secrecy under the SFO.

122. Because of the variety of conditions which might be encountered, the guidance in this Part of the Practice Note is necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with its lawyers when it encounters such circumstances.

123. Under the SFO the auditor has various statutory responsibilities to report to the SFC. The auditor is automatically protected in making a report in discharge of such a statutory responsibility. Certain provisions of the SFO also provide the auditor with immunity from any liability it might otherwise incur by reason of the auditor making other reports to the SFC which it may consider to be relevant to the functions of the SFC. These responsibilities and avenues available for reporting do not require the auditor to change the scope of its audit work, nor the frequency or timing of its visits.

124. When the circumstances where reporting may be appropriate are being considered, it should be noted that investments in financial markets carry inherent risks. It is not the purpose of the SFO, nor the duty of the auditor, to protect the investors from the normal risks relating to such investment activities.

125. The auditor needs to bear in mind that its decision may have to stand up to examination at a future date on the basis of the following considerations:

- a. what it knew at the time;
- b. what it should have known in the course of its audit;
- c. what it should have concluded; and
- d. what it should have done.

The auditor should report to the SFC under section 157 of the SFO promptly and not postpone reporting the breaches until the issuance of the audit report or the compliance report. In addition, taking into account the factors raised above, the auditor should report under section 157 of the SFO in sufficient detail to enable the SFC to understand the nature and circumstances of the situation.

## The auditor to lodge report with the SFC in certain cases

### Sections 157(1)(b) and 157(2) of the SFO

126. The auditor has a statutory duty to lodge a report with the SFC in the following circumstances:
- a. if it decides to include in its audit report any qualification or adverse statement (SFO section 157(1)(b)). Such a written report is required to be lodged with the SFC as soon as reasonably practicable after the auditor first proposes the inclusion of the qualification or adverse statement; and
  - b. if it resigns before the expiration of its term of office, intends not to seek re-appointment or otherwise cease to be the auditor (SFO section 157(2)). Such a notice in writing to notify the SFC is required within one business day of the event, outlining the reasons and any connected circumstances which the auditor considers should be brought to the attention of the SFC, or where there are no such circumstances state the fact.

### Section 157(1)(a) of the SFO

127. Section 157(1)(a) of the SFO provides that the auditor shall lodge a written report with the SFC, as soon as reasonably practicable after it becomes aware of any "reportable matter". A reportable matter is defined in section 157(3) of the SFO as:
- a. any matter which in the auditor's opinion adversely affects the financial position of the regulated entity to a material extent; or
  - b. a failure of the regulated entity to comply with any rules made under section 148, 149 or 151 of the SFO or a failure of the licensed corporation to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it.
128. These are statutory obligations and this Part of the Practice Note provides the auditor with procedures to follow when such circumstances arise.
129. Section 157(3) of the SFO includes a failure by the regulated entity to comply with any "prescribed requirement" as a "reportable matter". In addition to the requirements under any of the rules made under sections 148, 149 and 151 of the SFO, it also refers to the requirements under any of the rules made under section 152 of the SFO (provision of contract notes, receipts, statements of account and notifications by intermediaries and their associated entities). It should be noted that the requirements under any of the rules made under section 152 of the SFO are not included as "matters reportable by the auditor under section 157 of the SFO" in section 5 of the Securities and Futures (Accounts and Audit) Rules and therefore the auditor is not required to report to the SFC if there is a failure of the regulated entity to comply with section 152 of the SFO.

### *Reporting criterion under section 157(1)(a) of the SFO*

130. The auditor would take the initiative and ensure that a written report on the reportable matter under section 157(1)(a) of the SFO is lodged with the SFC if the conditions specified in paragraph 127 above exist. A distinction must be drawn here between an auditor's duty as stated in paragraph 127(a) and paragraph 127(b) above. The duty under paragraph 127(b) is clear and unequivocal: if the auditor becomes aware of a contravention of the requirements which are specified, it is not given any latitude for exercising judgment. The auditor is obliged to make a report. The duty under paragraph 127(a) is different. The auditor is given the right to form an opinion based on applying criteria as to the materiality of an adverse effect on the regulated entity's financial position in deciding whether reporting would be appropriate.

131. The HKICPA has developed a criterion for use by the auditor in deciding to take the initiative in lodging a written report with the SFC under paragraph 127(a) above. The criterion is that the auditor would lodge a written report with the SFC when it considers it expedient to do so in order for the SFC to protect the interests of investors because there has been a material loss or there exists a significant risk of material loss.
132. This criterion can be more fully explained as follows:
- a. there must be a significant adverse occurrence or a change in the auditor's perception of an existing situation, that may include an adverse change in the circumstances of the business; and
  - b. the situation described in (a) above has given rise to or has indicated that a reasonable probability exists that it may give rise to:
    - i. a material financial loss to the business which would result in a material deterioration of the licensed corporation's liquid capital position under the FRR; or
    - ii. loss of control over the assets or records.
133. Examples of the circumstances encountered in which the situation set out in paragraphs 131 and 132 may be met include:
- a. the auditor discovers a failure by the regulated entity to comply with the provisions of the SFO which may have material consequences; or
  - b. there is evidence of imminent financial loss of serious proportions which might cast doubt on the continuing viability of the regulated entity.

*Reporting procedures under section 157(1)(a) of the SFO*

134. In circumstances where the auditor concludes that a written report under section 157(1)(a) of the SFO to the SFC is necessary, it would adopt the following procedures, bearing in mind that speed may be of the essence:
- a. The auditor would discuss the matter with the regulated entity (unless the matter relates to suspected or actual instance of fraud and serious misconduct by the management itself) and explain the auditor's statutory duty to lodge a written report with the SFC under section 157(1)(a) of the SFO and that it might be advisable for the regulated entity to make a report direct to the SFC immediately.
  - b. The auditor would then immediately lodge a written report with the SFC. The auditor would follow this with a written notification along with a copy of its report to the directors or management to inform them.
135. The auditor would note that lodging a written report with the SFC alone may not discharge all its responsibilities. For example, the auditor would consider the implications of the matter giving rise to the report under section 157(1)(a) of the SFO for its opinion on the financial statements, and its conclusions in the Compliance Report.



## Other communications by the auditor

### Statutory protection under section 158 of the SFO

136. Section 158 (1) of the SFO provides that:

"... no duty which a person may be subject to as an auditor ... shall be regarded as contravened by reason of his communicating in good faith to the Commission ..., whether or not in response to a request made by the Commission ..., any information or opinion on a matter which (a) he becomes aware of in his capacity as such auditor (whether or not in the course of performing his functions as such auditor); and (b) is relevant to any function of the Commission ...".

137. Section 158 of the SFO only gives immunity for the auditor appointed under section 153 of the SFO. It does not cover appointments under section 159 or 160 of the SFO which give the power of appointment to the SFC. However it does extend the immunity to:

- a. an auditor who has ceased to be the auditor but became aware of a matter before his appointment ceased (SFO section 158(2)(a));
- b. an auditor appointed by a former regulated entity (SFO section 158(2)(b)); and
- c. an auditor who has ceased to be the auditor of a former regulated entity before his appointment ceased (SFO section 158(2)(c)).

138. Section 158 of the SFO does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the SFC. They provide a mechanism whereby the auditor may make matters known to the SFC with statutory protection from its duty of confidentiality.

139. This Part of the Practice Note contains guidance on the circumstances in which matters may be brought to the attention of the SFC by way of a report with statutory protection which falls outside those matters which the auditor is obliged to report (see paragraphs 126 to 135 above). In interpreting this guidance, the auditor would bear in mind the fundamental objectives of the SFO, which are to ensure that the SFC is able to fulfil its function of safeguarding the interests of investors. The auditor would have regard to any function of the SFC as summarized in section 5 of the SFO.

140. Confidentiality is an implied term of auditor's contract with its client, but in certain circumstances and under conditions specified in section 158 of the SFO it does not prevail, since the auditor of a regulated entity is entitled to communicate in good faith to the SFC information or opinion on a matter which it becomes aware of in its capacity as the auditor of the regulated entity and is relevant to any function of the SFC, without the duty of confidentiality owed to the client being regarded as having been contravened.

141. The matters which may be communicated under section 158 of the SFO depend on the functions of the SFC. Any matters relevant to any of its functions under the SFO may be communicated to the SFC.

142. Matters which may be reported under the protection of section 158 of the SFO will only arise in circumstances other than where the auditor is under a statutory duty to report under section 157 of the SFO. Considerable care needs to be taken in disclosing matters arising during any tripartite meeting with the SFC as the auditor's knowledge of these matters may have been obtained while assisting the SFC rather than in its capacity as the auditor (see paragraph 146 below).

143. Examples of circumstances in which the auditor may communicate any matter to the SFC under section 158 of the SFO include:
- a. the auditor considers investors have incurred, or are at significant risk of incurring, a material loss as a result of the regulated entity carrying on business in a manner that is not fit and proper;
  - b. there is evidence of:
    - i. fraud, dishonesty or serious incompetence; or
    - ii. serious failure to observe rules for the conduct of the regulated entity;
  - c. it has come to the attention of the auditor that the procedures, records or systems fail significantly to comply with, or to demonstrate compliance with, conduct of business requirements to which the regulated entity is subject (except in respect of client assets which are covered in section 157 of the SFO); and
  - d. the position is such that because of a significant risk which is material to the collective interests of investors, the investors' interests would be better safeguarded if the SFC were aware of the position, even if only to organize protective action.
144. Clearly the potential nature of matters which may be reported is very wide, but as explained in paragraph 147 below this does not, of itself, require the auditor to extend the scope of its work in order to discover matters and it will only be in exceptional circumstances such as those described in paragraphs 157 and 158 that it may choose to seek statutory protection.
145. Any protected communication can be made either on the auditor's initiative or in response to a request from the SFC for information. The auditor would cooperate with the SFC and respond to any requests from the SFC for information, provided it has no reason to doubt that the request is relevant to the SFC's functions. The auditor may communicate a matter to the SFC with the protection of section 158 of the SFO regardless of the source of that information, provided it became aware of the matter in its capacity as the auditor of the regulated entity and it does so in good faith.
146. Matters of which the auditor becomes aware "in its capacity as the auditor" may not be restricted to those matters identified during the course of the audit work by the auditor and members of the audit team. The auditor or members of the audit team may become aware of a matter which is relevant to the functions of the SFC during the course of its carrying out work for the regulated entity other than audit work or through private discussions on social or other occasions, in which case the information will be known to them as individuals. In circumstances which suggest that a matter would be reported to the SFC if knowledge of it had been obtained in the capacity as the auditor, it would be prudent to make enquiries in the course of the audit work in order to establish whether this is the case from information obtained in this capacity. In addition, a matter which is relevant to the functions of the SFC and which is identified during the course of work for the regulated entity by another partner (or member of staff) such as a management consultant or tax partner may be deemed to be known to the auditor (see also paragraph 147 below).
147. The auditor cannot be expected to be aware of all circumstances which, had it known of them, would have led them to exercise its right to communicate under section 158 of the SFO. This section does not require the auditor to change the scope of its audit or other work for the regulated entity, nor the frequency or timing of its visits. The auditor has no obligation to seek out grounds for making a report under section 158 of the SFO, the section does not place an obligation on the auditor to conduct its work in such a way that there is reasonable certainty that it will discover a matter upon which the SFC may need to act. It is only when the auditor does become aware in the ordinary course of this work of such a matter, or of circumstances which suggest the existence of such a matter, that it would consider using the protection of section 158 of the SFO.

148. The SFC recognizes that it would not be appropriate for the auditor to report information which it has obtained or matters which it has identified through its professional relationship with another client, even though the information obtained or the matters identified may relate to a regulated entity.
149. The auditor would need to realize that section 158 of the SFO will not provide protection where it could be held to have acted maliciously or in bad faith or if the information reported is outside the scope of the section. The SFO does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by their action in reporting to the SFC. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of its report are such as to secure the protection of section 158 of the SFO and that it only includes relevant material.
150. The auditor is protected, however, even if the information which it communicates subsequently falls short of proof, or the opinion which it communicates cannot be verified. The auditor who can demonstrate that it has acted reasonably and in good faith in informing the SFC of any information or opinion on a matter which it thinks has occurred would not be held in breach of duty to its client even if, after an investigation, it were found there was not a matter which needed to be reported. These are areas where the auditor may wish to consider taking legal advice before making a report.
151. Whilst no breach of statutory duty might arise, it should be appreciated that there is no protection given by the SFO if the auditor, after becoming aware of an occurrence, fails to report, promptly, or at all, to the SFC. Furthermore, the auditor would need to recognize that speed of reporting is likely to be important in order to enable the SFC to protect the interests of investors.

#### **Tripartite meetings**

152. As part of the SFC's system of supervision of regulated entities, meetings involving the SFC, the regulated entity and its auditor may be called by either the SFC, or the regulated entity possibly at the auditor's suggestion.
153. In such meeting, the auditor would be expected to discuss with the SFC the affairs of the regulated entity including:
  - a. the presentation and content of the financial statements;
  - b. the scope, conduct and outcome of the annual audit;
  - c. the scope, conduct and outcome of any report under section 158 of the SFO;
  - d. any points raised in the management letter which relate to the SFO;
  - e. explanations for, the reason for and nature of a qualified auditor's report or of a change in a previously reported intention to qualify an auditor's report;
  - f. any step or course of action which may be necessary in the light of the reports, for example, the commissioning of a more detailed report in a particular area (under section 159 or 160 of the SFO); and
  - g. matters raised by the SFC or those which the regulated entity or the auditor have drawn to its attention since any previous meeting, including how such matters have been resolved to the satisfaction of the auditor or have been reflected or treated in the financial statements.

### **Reporting via the regulated entity**

154. Where the auditor becomes aware of a matter which, in its professional judgment, it considers is not required to be reported under section 157 of the SFO but ought to be reported to the SFC, it would consider the facts and, unless inappropriate in the circumstances (described in paragraph 157 below), discuss the matter with the management.
155. It is important for the auditor to act in a manner that will maintain its professional relationship with its client. Normally, therefore, the auditor would ask the regulated entity to draw matters about which it is concerned to the attention of the SFC.
156. Where the regulated entity will not itself inform the SFC of a matter, having been advised to do so by the auditor, or where it has not been done within the period of time specified, or where there is no adequate evidence that the client has properly reported the matter in question, the auditor would make such a report direct to the SFC.

### **Reporting direct to the SFC**

157. In exceptional circumstances, where the auditor doubts whether management is fit and proper person to carry on business as a regulated entity and it would be in the interest of protecting investors that the management of the regulated entity would not be informed in advance, the auditor would report direct to the SFC after first considering the appropriateness of taking independent legal advice. Examples of these circumstances include:
  - a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where it believes that a fraud or other irregularity has been committed by the directors or senior management of the regulated entity, or it has evidence of the intention of directors or senior management to commit such a fraud or other irregularity; or
  - b. where there has been an occurrence which causes the auditor no longer to have confidence that the directors or senior management will conduct the business of the regulated entity in a prudent manner so as to protect the interests of investors, e.g. where it has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the affairs of the business or its clients, or it has evidence of their inclination so to act.
158. The auditor would also report direct to the SFC when speed is of the essence. For example, when it becomes aware that the regulated entity may be about to cease being licensed, the auditor would consider the need to disclose to the SFC any information in its possession relevant to its functions without delay. The fact of such impending cessation of licence may bring forward the desirability of disclosing matters to the SFC, as it is easier for the SFC to take appropriate action while the entity is still licensed, particularly where such matters bear on the security of third party interests.

### **The auditor's duty of secrecy**

159. Section 378 of the SFO imposes a duty of secrecy upon any "specified person", within the meaning of that term in section 378(15). The auditor is bound by the duty of secrecy once it performs any function under or carries into effect any of the provisions of the SFO or assists another person in the performance of any function under or in carrying into effect any such provisions.
160. The precise scope of an auditor's statutory duty of secrecy is not definitive but is likely to include:
  - a. any matter which, in the auditor's opinion, adversely affects the financial position of the regulated entity to a material extent and which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;

- b. any evidence of the regulated entity's failure to comply with any rules made under section 148, 149 or 151 of the SFO, or any evidence of the licensed corporation's failure to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it, which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;
  - c. the auditor's decision to resign before the expiration of its term of office, the auditor's decision not to seek re-appointment, or if the auditor otherwise ceases to be the auditor, and any reason for such decision which is communicated to the SFC under section 157(2) of the SFO;
  - d. any reason for including any qualification or adverse statement in the auditor's report on the regulated entity's financial statements (SFO section 157(1)(b)) which is communicated to the SFC to the extent that such reason is not self-evident from the contents of the report itself;
  - e. any communication by the auditor to the SFC under section 158 of the SFO, which is a communication of information or opinion on a matter which is relevant to any function of the SFC of which it becomes aware in its capacity as the auditor, whether or not it is at the time of such communication still the auditor of the regulated entity concerned; and
  - f. any communication by the SFC to the auditor under section 378(3)(h) of the SFO (see paragraphs 165 - 167 below).
161. Application of section 378 of the SFO would therefore prevent the auditor from communicating any matters such as those referred to in paragraph 160 above to any parties other than the SFC except under certain circumstances as discussed in paragraphs 162 and 163 below in relation to the matters mentioned in paragraph 160(c) above. It should be emphasised that application of section 378 of the SFO would also prevent the auditor from communicating information that is subject to the duty of secrecy to the regulated entity concerned except for information which the regulated entity already knows.
162. Section 210A(2) of the Companies Ordinance states that an auditor's notice of resignation shall not be effective unless it contains either (i) a statement to the effect that there are no circumstances connected with its resignation which it considers should be brought to the notice of the members or creditors of the company; or (ii) a statement of any such circumstances as aforesaid. Thus, the incoming auditor and members or creditors of a regulated entity may be informed by the outgoing auditor regarding its reasons to resign, not to seek re-appointment or otherwise cease to be the auditor. Disclosure of such information by the outgoing auditor of a regulated entity under the provisions of the Companies Ordinance is permitted under section 378(2)(e) of the SFO without breaching the duty of secrecy under section 378 of the SFO since the disclosure is made in accordance with a law.
163. In complying with a request by the incoming auditor to provide professional clearance which is required under HKICPA Code of Ethics for Professional Accountants, the outgoing auditor may communicate the matters referred to in paragraph 160(c) to the incoming auditor. The outgoing auditor is considered to be doing this for the purposes of carrying into effect the provisions of section 153 of the SFO in order that the incoming auditor can accept nomination as the auditor of the regulated entity under section 153 of the SFO.
164. Under this Practice Note, the auditor would prepare two auditor's reports separately in respect of reporting on the financial statements (see paragraph 85 above) and compliance reporting (see paragraph 87 above). Since the Compliance Report by the auditor is for filing with the SFC only and should not be made available to any other parties including the shareholders of the regulated entity, the auditor can disclose any contraventions by the regulated entity of the requirements referred to in paragraph 160(b) in the Compliance Report without breaching the duty of secrecy under section 378 of the SFO.

### **Communications by the SFC to the auditor under section 378(3)(h) of the SFO**

165. Section 378(3)(h) of the SFO empowers the SFC to disclose confidential information to the auditor of regulated entities for the purpose of enabling or assisting the SFC to perform its functions under the SFO without the consent of the person from whom it is received or to whom it relates. It should be noted that disclosure by the SFC of confidential information to the auditor is to the auditor only; it is not free to pass that information to others, such as its client regulated entity without the consent in writing of the SFC.
166. The SFC will generally take the initiative in bringing a matter to the attention of the auditor of a regulated entity under the provisions of section 378(3)(h) of the SFO if it considers disclosure is necessary to enable or assist the SFC to perform its functions under the SFO. Where the SFC discloses confidential information to the auditor under section 378(3)(h) of the SFO, it will generally inform the auditor whether it has informed the regulated entity's management of the matter and, if so, whom.
167. If the auditor is not informed by the SFC of any such matter, it is entitled to assume that the SFC has no such disclosure to make. Accordingly, there is no need for the auditor to request the SFC to confirm this.

## APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS

### Example 1 - auditor's report on financial statements - regulated entity

#### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF ABC SECURITIES LIMITED

(incorporated in Hong Kong with limited liability)<sup>1</sup>

#### Report on the Financial Statements

We have audited the financial statements of ABC Securities Limited ("the Company") set out on pages ..... to....., which comprise the [balance sheet][statement of financial position]<sup>2</sup> as at 31 December 20X1,<sup>3</sup> and the [income statement][statement of comprehensive income]<sup>2</sup>, statement of changes in equity and [cash flow statement][statement of cash flows]<sup>2</sup> for the year then ended, and a summary of significant accounting policies and other explanatory information.

#### *Directors' Responsibility for the Financial Statements*

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In addition, the directors also have a responsibility to ensure that the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>4</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, and whether the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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<sup>1</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>2</sup> Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

<sup>3</sup> For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities.

<sup>4</sup> The auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

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

*Opinion*

In our opinion, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1 and of its [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

**Report on matters under the Hong Kong Securities and Futures (Keeping of Records) Rules and Hong Kong Securities and Futures (Accounts and Audit) Rules of the Hong Kong Securities and Futures Ordinance**

In our opinion, the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report



## Example 2 - compliance report by the auditor - licensed corporation

### COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC SECURITIES LIMITED

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*]<sup>2</sup> for submission by the company to the Hong Kong Securities and Futures Commission ("SFC").

#### Respective responsibilities of directors and auditor

In relation to this Compliance Report, the directors have a responsibility to ensure that:

- a. each of the returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] is correctly compiled from the records of the company;
- b.<sup>1</sup> the company has systems of control in place that are adequate to ensure compliance with:
  - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
- c. the company has complied with:
  - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- d. the company has complied with the Hong Kong Securities and Futures (Financial Resources) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusions 1(a) and 1(c) below, we have performed such procedures as we considered necessary.

[In relation to our conclusion 1(b) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.]<sup>1</sup>

In relation to our conclusion (2) below, we are not required to perform any procedures to search for instances of contravention of the Hong Kong Securities and Futures (Financial Resources) Rules.

### **Inherent limitations**

Systems of controls designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Such measures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust.

### **Conclusion**

Based on the foregoing:

1. in our opinion:
  - a. the company has correctly compiled the attached returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] from the records of the company;
  - b.<sup>1</sup> during the year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
    - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - ii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
  - c. during the year ended [*year end date*], the company has complied with:
    - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
    - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
2. during the year ended [*year end date*], we are not aware of any instances where the company has contravened the Hong Kong Securities and Futures (Financial Resources) Rules.

## Use of this report

This report is intended solely for submission by the company to the SFC and is not intended to be, and should not be, used by anyone for any other purpose.

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable where the licensed corporation does not hold client assets. Refer to paragraph 68 of Appendix 2 for more guidance.*

Where the licensed corporation does not hold assets, the auditor is encouraged to include either one of the following paragraphs after the first paragraph of the example compliance report:

- (a) The licensed corporation is subject to the licensing condition that it shall not hold client assets. *[This paragraph is applicable to licensed corporations / associated entities who are not licensed to hold client assets.]*
- (b) The licensed corporation is permitted to hold client assets however no client assets were held during the year. *[This paragraph is applicable to licensed corporations / associated entities who are licensed to but does not hold client assets.]*

*Note 2: For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities.*

### **Example 3 - compliance report by the auditor - associated entity of intermediary**

#### **COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC NOMINEE LIMITED**

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*]<sup>2</sup> for submission by the company to the Hong Kong Securities and Futures Commission (SFC).

#### **Respective responsibilities of directors and auditor**

In relation to this Compliance Report, the directors have a responsibility to ensure that:

- a. the company has systems of control in place that are adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### **Basis of conclusion**

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusion (a) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Technique and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.

In relation to our conclusion (b) below, we have performed such procedures as we considered necessary.

### **Inherent limitations**

Systems of controls designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Such measures cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust.

### **Conclusion**

Based on the foregoing, in our opinion:

- a. during the year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. during the year ended [*year end date*], the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

### **Use of this report**

This report is intended solely for submission by the company to the SFC and is not intended to be, and should not be, used by anyone for any other purpose.

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable in the case of an associated entity of a registered institution.*

*Note 2: For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the date that the entity ceases to be an associated entity.*

## APPENDIX 2 - CLIENT ASSETS

### INTRODUCTION

1. This Appendix provides more detailed guidance to the auditor on the work normally carried out in order to form an opinion on client assets in the auditor's reporting under the SFO. It provides guidance on the following rules:
  - a. Securities and Futures (Client Securities) Rules (Client Securities Rules);
  - b. Securities and Futures (Client Money) Rules (Client Money Rules);
  - c. Securities and Futures (Keeping of Records) Rules (Keeping of Records Rules); and
  - d. Securities and Futures (Accounts and Audit) Rules.

For the purpose of this Appendix the term "rules" means any of the above applicable rules.

2. The main purpose of the rules in relation to client assets is to ensure that the regulated entity safeguards client assets. A further purpose is to ensure that, in the event of insolvency of the regulated entity, client assets are protected from the claims of its general creditors and, in the case of client money, from any right of set off by institutions which hold the money.
3. The rules require a regulated entity to maintain a high standard of custodianship and associated record keeping. Management of a regulated entity is responsible for establishing and maintaining adequate accounting records and systems and controls. In this regard, the SFC has issued guidance to licensed corporations in the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules. This recognizes the position of trust under which client assets are held.
4. This Appendix is separated into three sections as follows:
  - a. client securities;
  - b. client money; and
  - c. no client assets.

The sections on client securities and client money also set out the relevant planning considerations.

5. This Appendix is to assist the auditor in determining the scope of the work for each individual audit. However it is not intended to limit or replace individual professional judgment, initiative and vigilance. Audit procedures are designed to meet the requirements of the particular situation, giving careful consideration to the size and type of regulated entity and the system of internal accounting control; this is a matter that requires the exercise of professional judgment in the light of the circumstances of each particular case.
6. Where the auditor discovers that the systems have failed or material differences have arisen, it considers the implications these may have on other areas of its work, on its reporting obligations and, in particular, on the "truth and fairness" of the financial statements.

## CLIENT SECURITIES

### Introduction

7. Client securities, for the purpose of the Client Securities Rules, are securities that are:
  - a. either
    - i. listed or traded on a recognised stock market; or
    - ii. interests in a collective investment scheme authorized by the SFC under section 104 of the SFO; and
  - b. received or held in Hong Kong by or on behalf of
    - i. a licensed corporation in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or
    - ii. an associated entity of an intermediary in relation to the conduct of any regulated activity.

These securities may be held in the form of collateral.

8. The Client Securities Rules do not apply to client securities of a licensed corporation that are in an account established and maintained by a client of the licensed corporation, in that client's name, with a person other than the licensed corporation or an associated entity of the licensed corporation. The Client Securities Rules do not apply to client securities that are received or held outside Hong Kong by a licensed corporation or its associated entity.
9. For the particular regulated activity, the auditor needs to understand what may constitute client securities that are covered by the Client Securities Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client securities, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Securities Rules as a result.

### Planning

10. The auditor's work on client securities will be planned in relation to three reporting requirements. For client securities, the main areas that need to be addressed by the auditor, to enable them to fulfill its reporting requirements, are:
  - a. whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with the sections 4(4), 5, 10(1) and 12 of the Client Securities Rules;
  - b. whether during the period under review, the regulated entity has complied with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules; and
  - c. whether during the period under review, the regulated entity has complied with section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client securities.
11. The control objectives that a regulated entity administering or holding client securities or securities collateral will need to meet and the evidence that may be available to the auditor upon which it can base its conclusions are outlined below. They are only indicative.
12. Not every regulated entity, particularly a smaller one, will be able to meet all these objectives through the establishment of formal controls and segregation of duties. In consequence, not all the evidence indicated below will be available in every case.

13. This does not necessarily mean that the regulated entity has weak controls or that there is insufficient evidence for the auditor to give a conclusion. The regulated entity may well have adequate controls due to close supervision by the management, taking into account the low volume of client securities handled.
14. In some cases, therefore, the auditor may place greater reliance on observation and enquiry for its audit evidence than inspection of documentation. In doing so, it needs to bear in mind that undocumented systems are more prone to error and fraud, and that its presence and enquiries may influence the manner in which procedures are operated at that time.

#### **Adequate systems of control - Timely renewal of standing authorities (section 4(4))**

##### **Control objectives - Timely renewal of standing authorities**

15. The main factors that will be considered are:
  - a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;
  - b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
  - c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

##### **Evidence - Timely renewal of standing authorities**

16. The main factors that will be considered are:
  - a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current standing authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.

#### **Adequate systems of control - Deposit or registration of client securities and securities collateral (section 5)**

##### **Control objectives - Deposit or registration of client securities and securities collateral**

17. The main factors that will be considered are:
  - a. whether registerable client securities are registered in a name permitted by the rules;
  - b. where client securities are deposited in the same name as that used for the intermediary's house positions, that the client securities are deposited in a designated account different from that in which its house positions are deposited;
  - c. securities held as collateral can be separately identified;



- d. arrangements for releasing documents under stock lending and borrowing arrangements are in accordance with the rules;
- e. satisfactory arrangements for ensuring that the client securities were held or securities collateral kept after receipt in a segregated account or registered in the name of the client from whom or on whose behalf the client securities have been received, or the intermediary (applicable to securities collateral only) or associated entity;
- f. satisfactory arrangements for ensuring that where client securities and securities collateral are deposited in safe custody, that the financial institutions, custodians or other intermediaries in question are appropriately authorized, approved or licensed as appropriate;
- g. satisfactory arrangements for withdrawal or disposal of client securities and securities collateral to be made to or by the client, or to or by any authorized party as specified in sections 5 and 6 of the Client Securities Rules upon the circumstances or under discretionary powers given in the client agreement;
- h. risk assessments to be carried out on all custodians to assess the risk of placing client securities and securities collateral with a third party;
- i. written arrangements between the intermediary or associated entity and the custodian covering at least the minimum requirements of the rules; and
- j. an adequate system to ensure that statements are sent to clients at required intervals, and that such statements properly reflect the regulated entity's records.

**Evidence - Deposit or registration of client securities and securities collateral**

18. The main factors that will be considered are:
- a. written instructions from clients stating the manner in which their securities are to be registered; these instructions may be set out in standard client agreements;
  - b. written procedures setting out how each security is to be identified so as to reflect the client's entitlement to that security (e.g. registered in the client's name);
  - c. where client securities are registered in the name of the intermediary or an associated entity, that an appropriate record of the interests of individual clients is maintained;
  - d. clear segregation of client securities from other securities;
  - e. separate registers maintained of securities held as collateral;
  - f. evidence of appropriate authority to engage in stock lending arrangements, given to the regulated entity by the clients concerned;
  - g. separate records of all such transactions sufficient to show the details of the stocks lent at any time and the collateral held;
  - h. proper segregation of duties which ensure each area is staffed by people independent of any other operations and password controls;
  - i. qualifications and experience of senior management;
  - j. strong boxes, fire-proof rooms and safes, restricted access via password controlled doors or limited access to keys, especially where important documents like securities certificates, were kept in the office premise;

- k. regular stock reconciliations performed for each stock segregated account against third party supporting documents;
- l. follow up actions taken by the licensed corporation on any reconciling or unusual entries in the stock records, particularly negative stock balances;
- m. evidence of spot checks of the custodian area by the compliance or internal audit department;
- n. written procedures stating how custodian staff are to process the movement of securities and what is required in the form of authorization;
- o. evidence of procedures for selection of external financial institutions, custodians or other intermediaries to ensure that they are eligible and suitable to hold client securities and securities collateral in safe custody;
- p. results of a risk assessment process including external information on credit rating, financial results etc. of the custodian and internal information on customer service received;
- q. letters of agreement with custodians stating the terms under which they are operating;
- r. file copies of statements sent to clients, which agree with the records; and
- s. procedures and controls (e.g. completed checklist) to ensure that all clients receive a statement (where required).

**Adequate systems of control - Depositing and transferring client securities and securities collateral (section 10(1))**

19. Under section 10(1) of the Client Securities Rules a regulated entity is required to take reasonable steps to ensure that client securities and securities collateral of the intermediary are not:
- i. deposited;
  - ii. transferred;
  - iii. lent;
  - iv. pledged;
  - v. repledged; or
  - vi. otherwise dealt with,

except as provided in Part 2 of the Client Securities Rules.

The relevant elements of the Client Securities Rules in Part 2 (covering sections 5, 6, 7, 8 and 9) in summary cover the following:

- a. *Section 5 - requirements for deposit or registration of client securities and securities collateral*

Unless client securities and securities collateral are registered in the name of the client, or the associated entity (or the intermediary in the case of securities collateral):

- i. client securities are:
  - deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities;
- ii. securities collateral is:
  - deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities; or
  - deposited in an account in the name of the intermediary or associated entity with authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities.

*b. Section 6 - dealings with client securities and securities collateral*

A regulated entity may deal with client securities or securities collateral in accordance with:

- i. an oral or written direction to sell or to settle such a sale order;
- ii. a written direction to withdraw the client securities or securities collateral (where required under section 5);
- iii. a standing authority, except where this will result in:
  - a transfer of client securities or securities collateral to an account in Hong Kong other than an account referred to in section 5 or otherwise result in the intermediary, associated entity or a related corporation of the intermediary having the benefit or use of the client securities or securities collateral;
  - a transfer of the client securities or securities collateral to an officer or employee, unless he is the client in question; or
  - an unconscionable transaction in the sense of the Unconscionable Contracts Ordinance.

Where a licensed corporation is licensed for asset management, with the written agreement of the client, the licensed corporation may withdraw client securities from a trust account or client account, or deal with client securities that have been registered in the name of the client or an associated entity, for the purpose of selling the securities or settling a sale order on behalf of the client.

Where there is a liability owed by or on behalf of a client, with that client's written agreement, a licensed corporation may dispose, or initiate a disposal by any of its associated entities, of any of the client securities or securities collateral in settlement of that liability.

*c. Section 7 - treatment of client securities and securities collateral by intermediaries licensed for dealing in securities and their associated entities*

With a standing authority a licensed corporation licensed for dealing in securities may:

- i. apply any of the securities or securities collateral pursuant to a securities borrowing or lending agreement;

- ii. subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, deposit any of the securities collateral in question with an authorized financial institution as collateral for financial accommodation provided; or
  - iii. deposit any of the securities collateral in question with a recognised clearing house or another intermediary licensed or registered for dealing in securities as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.
- d. *Section 8 - treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities*

Subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, with a standing authority a licensed corporation licensed for securities margin financing may deposit any of the securities collateral that it receives with an authorized financial institution or an intermediary licensed for dealing in securities as collateral for financial accommodation provided to the licensed corporation.

- e. *Section 8A – repledging*
- i. A regulated entity is required to ascertain the closing aggregate market value of the repledged securities collateral for each business day does not exceed 140% of its aggregate margin loan on the same date;
  - ii. If such 140% limit has been exceeded on any business day, the regulated entity is required to withdraw any excess to reduce such ratio to below the limit by the end of the next business day.
- f. *Section 9 - treatment of securities collateral by intermediaries licensed for dealing in futures contracts and their associated entities*

With a standing authority a licensed corporation licensed for dealing in futures contracts may deposit any of the securities collateral that it receives with a recognised clearing house or an intermediary licensed or registered for dealing in futures contracts as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.

**Control objectives - Depositing and transferring client securities and securities collateral**

20. The control objectives that have been included in paragraph 17 above apply here. Additional factors that will be considered are:
- a. written procedures in place covering client dealing and transfer instructions;
  - b. controls provide assurance that client instructions are authorized prior to being actioned;
  - c. standing authorities are valid and current;
  - d. transfers of client securities and securities collateral are made to appropriate authorized accounts;
  - e. controls provide assurance that at the end of each business day repledged securities – that exceed 140% of aggregate margin loans are promptly identified and rectification action is taken within the following business day in accordance with the rules; and
  - f. where a client has failed to deliver the stock to the licensed corporation to settle his sale order, the securities of other clients are not used to settle the obligations of the client except as provided in Part 2 of the Client Securities Rules.

**Evidence - Depositing and transferring client securities and securities collateral**

21. The main factors that will be considered are:
- a. availability of up-to-date written procedures covering the handling of client instructions;
  - b. evidence that client instructions are verified as authentic and valid before being actioned;
  - c. evidence that client standing orders are checked that they are current and cover the transaction in question each time they are used;
  - d. evidence that where appropriate client securities and securities collateral are only transferred to or deposited with authorized financial institutions, approved custodians or other intermediaries licensed for dealing in securities;
  - e. where the licensed corporation has both cash clients and margin clients, the auditor should check whether separate designated accounts are maintained;
  - f. where client securities are maintained through CCASS, to determine whether securities received are allocated and transferred to the appropriate account within the timeframe as specified by the rules;
  - g. whether the licensed corporation has taken effective actions to follow up on any negative stock balance in its stock records and client ledger; and
  - h. the maximum amount of securities that the licensed corporation is permitted under section 8A of the Client Securities Rules to repledge is calculated on an ongoing basis and compared with the aggregate value of securities actually repledged, and rectification action is carried out within the statutory timeframe for any breach of the limit.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 12)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

22. The main factors that will be considered are:
- a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined in section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

23. The main factors that will be considered are:
- a. evidence that the business has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

### **Compliance with the rules**

24. The work that the auditor will have performed as outlined above in relation to determining whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules is likely to also enable it to report on whether during the period under review, the regulated entity has complied with sections 4(4), 5, 10(1) and 12 of the Client Securities Rules.

Depending on the results of the work on the systems of control, some additional testing is likely to be required to enable the auditor to issue its opinion on the regulated entity's compliance with the rules during the period under review.

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

### **Adequate accounting records have been maintained**

#### **Control objectives - Adequate accounting records have been maintained**

25. The main factors that will be considered are:
- a. proper and prompt recording of the movements of documents (this includes all documents, including those relating to the regulated entity's own securities as there is a risk of teeming and lading and having client documents mixed with the regulated entity's own documents);
  - b. proper and prompt recording of all purchases and sales of securities on behalf of clients;
  - c. records in agreement with the statements sent to clients of assets held on their behalf;
  - d. reconciliations carried out in accordance with the rules; and
  - e. proper and prompt accounting for benefits, such as bonus or scrip issues accruing to clients.

#### **Evidence - Adequate accounting records have been maintained**

26. The main factors that will be considered are:
- a. evidence that documents of title are recorded immediately on receipt;
  - b. evidence that documents of title are not released from the regulated entity's control to clients, registrars, brokers, etc. without the records being amended;
  - c. records kept in respect of any document clearly setting out the date of receipt and despatch of the document, the nature of the document, the client to whom the document relates, and the nature, amount and nominal value of the securities to which the document relates;
  - d. evidence that statements are sent to clients at the required intervals, made up to the appropriate date, and properly specifying the documents held. In this context, the auditor may consider obtaining direct confirmation from clients;
  - e. evidence that correspondence from clients querying statements (including client complaints) and any other queries have been dealt with properly and promptly;
  - f. evidence that benefits such as dividends or scrip issues are collectively and correctly allocated to each client;

- g. evidence that reconciliations have been carried out in accordance with the rules (for more detailed guidance on reconciliations see paragraphs 28 to 36 below); and
  - h. circularisation of account balances in accordance with paragraph 27 below.
27. The auditor exercises its professional judgment to determine whether and how to go about the performance of a circularisation of clients' account balances. The SFC has issued a list of matters which may be taken into account by the auditor in conducting a circularisation of clients' account balances:
- a. the auditor would exercise its judgment in determining sufficient coverage of samples over the total population of clients' accounts both in terms of number of clients and the money value of clients' assets;
  - b. a risk-based approach should be adopted for sampling client accounts for circularisation whereby greater emphasis is placed on accounts which are more susceptible to misstatement or frauds, such as accounts under an arrangement to hold mail or to direct mail to the address of management or staff of the licensed corporation, inactive and dormant accounts etc;
  - c. appropriate audit steps should be taken to ensure the completeness of the list of clients from which samples are drawn;
  - d. confirmation would be prepared in language that the clients of the regulated entity are familiar with;
  - e. confirmation would be directly sent to and received from clients. Clients would be provided with convenient means of responding to the auditor;
  - f. be aware of any client enquiries regarding any discrepancies in their account balances;
  - g. the auditor would independently select samples for circularisation;
  - h. the auditor should ensure that the client particulars (such as the name and address of the client) stated in statements of account to be sent to the clients for confirmation agree to the licensed corporation's latest client information. Furthermore, the auditor should also ensure that the account balances and securities holding in the statements of account sampled for confirmation are consistent with the licensed corporation's relevant records. For example, holdings in each stock as stated in the statements of account should be checked against the underlying accounting records and stock ledgers, which should be reconciled with custodians' statements and/or physical stock count results with discrepancies properly followed up.
  - i. to improve the number of replies it is advisable to send the confirmation out as close as possible to the date that the licensed corporation has sent out its monthly statements.
  - j. the auditor to determine appropriate procedures in assessing the reliability of the confirmation letters received such as verifying client signatures on the confirmation against client agreements and/or directly calling the clients to verify the agreed balances on a sample basis; and
  - k. adequate and timely follow-up procedures for the non-reply confirmations would be carried out such as considering sending reminders or directly calling the non-reply clients etc. and/or reviewing a sample of trade orders and withdrawals of funds and securities recorded in their accounts.

## Reconciliations

28. The requirement to carry out reconciliations is set out in the Keeping of Records Rules. Further guidance on client asset reconciliation is set out in the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules.

*Control objectives - Reconciliation of client securities - Physically held client securities*

29. The main factors that will be considered are:
- a. physical counts and reconciliations of all securities performed with at least the frequency and in the manner required by the rules, and by staff (in so far as possible) independent of the custodian department;
  - b. procedures planned and implemented to ensure that the count of client title documents is accurate;
  - c. timely clearance of reconciling items; and
  - d. records retained of the dates and results of the physical counts.

*Evidence - Reconciliation of client securities - Physically held client securities*

30. The main factors that will be considered are:
- a. detailed instructions for the counts;
  - b. an independent function (such as compliance department or internal audit) organizing, controlling or participating in carrying out the counts and reconciliations;
  - c. sufficient time and resources devoted to the counts and reconciliations;
  - d. full and clear documentation of the counts and reconciliations;
  - e. counts carried out at the frequency and with the time limits required by the rules;
  - f. adequate explanations for reconciling items; and
  - g. completion of reconciliations (i.e. all items explained).

*Control objectives - Reconciliation of client securities - Client securities held by a custodian*

31. The main factors that will be considered are:
- a. reconciliations for all custodians performed with at least the frequency and in the manner required by the rules and the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules;
  - b. timely clearance of reconciling items;
  - c. the reconciliations undertaken by a person who is not involved with the recording or movement of the assets, if the size of the regulated entity permits this segregation of duties; and
  - d. records retained of the dates and results of reconciliations including confirmations from external custodians.



*Evidence - Reconciliation of client securities - client securities held by a custodian*

32. The main factors that will be considered are:
  - a. an independent function carrying out the reconciliations;
  - b. sufficient time and resources devoted to reconciliations;
  - c. full and clear documentation of the reconciliations;
  - d. reconciliations carried out at the frequency required by the rules;
  - e. adequate explanations for reconciling items; and
  - f. completion of reconciliations (i.e. all items explained).
33. Where client securities are physically held by the regulated entity itself, the auditor may attend part or all of one of the physical counts of client title documents. In reaching a conclusion regarding the extent to which this is necessary, the auditor considers the strength of controls surrounding, and the independence of, the count, reconciliation, day to day processing and custody of client documents of title.
34. The auditor examines confirmations from independent custodians of documents of title held by them.
35. The auditor inspects correspondence and agreements with custodians in order to verify compliance with the rules.
36. In larger regulated entities, a rolling reconciliation basis of confirming client title documents (similar to a manufacturing company's system of perpetual stock-taking) is sometimes adopted. Care must be taken to ensure that systems and controls are in place to prevent teeming and lading.

## **CLIENT MONEY**

### **Introduction**

37. The Client Money Rules apply to client money of a licensed corporation that is received or held by or on behalf of:
  - a. the licensed corporation, in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or
  - b. an associated entity of the licensed corporation where such an associated entity is not an authorized financial institution, in relation to such conduct of the regulated activity.

The Client Money Rules do not therefore apply to associated entities of registered institutions. The reference to "regulated entity" in this section below is therefore restricted to a licensed corporation or its associated entity that is not an authorized financial institution.

38. The Client Money Rules do not apply to client money of a licensed corporation that is received or held outside Hong Kong by the licensed corporation or an associated entity of the licensed corporation.
39. The Client Money Rules do not apply to client money of a licensed corporation that is in a bank account established and maintained by a client of the licensed corporation in that client's name.

40. For the particular regulated entity, the auditor needs to understand what may constitute client money that is covered by the Client Money Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client money, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Money Rules as a result.

### **Segregated accounts**

41. When a regulated entity holds or expects to hold client money, it must open one or more segregated accounts, each of which shall be designated as a trust account or client account. These must be established and maintained with:
- a. an authorized financial institution; or
  - b. any other institution approved by the SFC for the purposes of the Client Money Rules, either generally or in a particular case.

### **Planning**

42. The auditor's work on client money will be planned in relation to the three reporting requirements. For client money, the main areas that need to be addressed by the auditor, to enable it to fulfil its reporting requirements are:
- a. whether during the period under review, the regulated entity had systems of control in place that were adequate to ensure compliance with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules;
  - b. whether during the period under review, the regulated entity has complied with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules; and
  - c. whether during the period under review, the regulated entity has complied with section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client money.
43. The control objectives that the auditor would expect to see in a regulated entity holding client money and the evidence from which the auditor seeks to draw reasonable conclusions are outlined below. They are only indicative and will not be applicable to all regulated entities holding client money, especially smaller ones.

### **Adequate systems of controls - Payment of client money into segregated accounts (section 4)**

44. Client money held by regulated entities has to be held on trust for clients in one or more segregated bank accounts designated as a trust account or client account.

#### **Control objectives - Payment of client money into segregated account**

45. The main factors that will be considered are:
- a. all client money is paid within one business day into a segregated account;
  - b. bank accounts opened only with an authorized financial institution, or any other institution approved by the SFC for the purposes of the Client Money Rules;
  - c. bank accounts include "Client Account" or "Trust Account" in their description in accordance with section 4(1) of the Client Money Rules;
  - d. appropriate statements, confirmations and agreements sent to and received from the authorized financial institutions;

- e. systems are adequate to identify all client money;
- f. systems are adequate to ensure that all client money and only client money is paid in compliance with the rules (other than where it is specifically allowed by the rules);
- g. systems are adequate to ensure that all client money is paid in promptly; that is within one business day, unless otherwise disposed of in accordance with the rules; and
- h. client money is only applied for the purposes of the client to whom it relates.

**Evidence - Payment of client money into segregated accounts**

46. The main factors that will be considered are:
- a. clear internal instructions setting out the procedures to be followed in dealing with any potential client money;
  - b. suitable levels of staff (i.e. with the appropriate training and experience) responsible for establishing segregated accounts and identifying client money within the regulated entity;
  - c. lodgements regularly and promptly made;
  - d. lodgements to segregated accounts comprise client money only, except as otherwise permitted;
  - e. lodgements to non client accounts do not include client money;
  - f. an up to date list of all bank accounts which identifies those that are segregated accounts; and
  - g. bank statements agreeing to the regulated entity's records.

**Adequate systems of controls - Payment of client money out of segregated accounts (section 5)**

**Control objectives - Payment of client money out of segregated accounts**

47. The main factors that will be considered are:
- a. systems are adequate to ensure that all client money withdrawals in Hong Kong are made in compliance with the rules; and
  - b. all withdrawals from segregated accounts are made only for prescribed purposes and in accordance with the rules.

**Evidence - Payment of client money out of segregated accounts**

48. The main factor that will be considered is:
- a. withdrawals are properly authorized and for purposes approved by the rules.

**Adequate systems of controls - Treatment of interest on client money held in segregated accounts (section 6)**

49. The Client Money Rules require that interest derived from client money is held in a segregated account. To the extent that any amount of interest retained in a segregated account which the regulated entity is entitled to retain under an agreement with the client(s), this would be paid out of the account within one business day after the interest is credited to the account or the regulated entity becomes aware that the interest has been credited to the account.

**Control objectives - Treatment of interest on client money held in segregated accounts**

50. The main factors that will be considered are:
- a. appropriate procedures in place for identifying and withdrawing regulated entity's entitlement of interest on segregated accounts on a timely basis;
  - b. where applicable, interest paid on all money subject to interest calculations; and
  - c. interest payments correctly calculated by reference to the appropriate dates.

**Evidence - Treatment of interest on client money held in segregated accounts**

51. The main factors that will be considered are:
- a. evidence that regulated entity's interest entitlements are withdrawn on a timely basis in accordance with the rules; and
  - b. schedules showing how interest due to clients has been calculated (or equivalent computer processes).

**Adequate systems of control - Timely renewal of standing authorities (section 8(4))**

**Control objectives - Timely renewal of standing authorities**

52. The main factors that will be considered are:
- a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;
  - b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
  - c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

**Evidence - Timely renewal of standing authorities**

53. The main factors that will be considered are:
- a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.

**Adequate systems of controls - Requirement to pay money other than client money out of segregated accounts (section 10)**

54. The Client Money Rules require that a regulated entity which becomes aware that it is holding an amount of money in a segregated account that is not client money of the regulated entity shall, within one business day of becoming so aware, pay that amount of money out of the segregated account.

**Control objectives - Requirement to pay money other than client money out of segregated accounts**

55. The main factor that will be considered is appropriate procedures in place for identifying and withdrawing regulated entity's money from segregated accounts on a timely basis.

**Evidence - Requirement to pay money other than client money out of segregated accounts**

56. The main factor that will be considered is evidence that regulated entity's money is withdrawn on a timely basis in accordance with the rules.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 11)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

57. The main factors that will be considered are:
- a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined by section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

58. The main factors that will be considered are:
- a. evidence that the regulated entity has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

**Compliance with the rules**

59. The work that the auditor will have performed as outlined above in relation to determining whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules is likely to also enable them to report on whether during the period under review, the regulated entity has complied with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules.

Depending on the results of the work on the systems of control, some additional testing is likely to be required to enable the auditor to issue its conclusion on the regulated entity's compliance with the rules during the period under review.

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

### **Adequate accounting records have been maintained**

#### **Control objectives - Adequate accounting records have been maintained**

60. The main factors that will be considered are:
- a. proper recording of movements of client money;
  - b. interest credited in accordance with the rules;
  - c. reconciliations carried out in accordance with the rules; and
  - d. appropriate titles are given to accounts.

#### **Evidence - Adequate accounting records have been maintained**

61. The main factors that will be considered are:
- a. adequate details of the day to day entries of money paid into and out of the segregated accounts and individual client accounts including:
    - i. dates of receipts and payments;
    - ii. name of the client;
    - iii. name of the person from whom money was received or to whom it was paid, if other than the client;
    - iv. sub-ledgers with individual client accounts; and
    - v. evidence of designation from a client;
  - b. records of the interest earned on the segregated accounts, the determination of the amount of interest payable to clients and the dates and amounts of interest paid/credited to clients;
  - c. records maintained on a timely basis;
  - d. evidence that reconciliations have been carried out as required and reconciling items have been investigated and cleared promptly (for more detailed guidance on reconciliations see paragraphs 62 to 67 below);
  - e. the records maintained comply with the guidance given by the SFC;
  - f. to provide third party evidence of client balances (except settlement balances), the auditor may consider obtaining direct confirmation from clients; in practice, this may be conveniently combined with testing the accuracy of statements of their securities sent to clients; and
  - g. circularisation of account balances in accordance with paragraph 27 of this Appendix.

#### **Reconciliations**

62. The requirement to carry out reconciliations is set out in the Keeping of Records Rules.

63. Regulated entities that hold client money are required to reconcile each month any differences during that month in its balances or positions with any of their associated entities and other parties, including:
- a. recognised exchange companies;
  - b. clearing houses;
  - c. other intermediaries;
  - d. custodians; and
  - e. banks,

and show how such differences were resolved.

*Control objectives – Reconciliation*

64. The main factors that will be considered are:
- a. client/trust money per the segregated account, as recorded by the regulated entity, is reconciled with the total of balances recorded as due to each client at least each month;
  - b. balance of each such segregated account, as recorded by the regulated entity, is reconciled with the relevant bank statements;
  - c. the reconciliations are properly prepared and adequate explanations given for reconciling items, which would be cleared without delay; and
  - d. records are retained of the dates and results of the reconciliations.

*Evidence – Reconciliation*

65. The main factors that will be considered are:
- a. an up-to-date list of the segregated accounts held that agrees with the segregated accounts being reconciled;
  - b. evidence of an independent preparation and review of these reconciliations; and
  - c. reconciliations being carried out regularly over the period under review.
66. The auditor carries out normal audit tests on bank reconciliations. Particular attention will be paid to reconciling items, ensuring that outstanding and uncleared items are properly identified and are duly cleared shortly after the reconciliation. As part of its substantive testing, the auditor examines and where appropriate obtain direct confirmation of bank balances from each bank concerned.
67. The regulated entity would also reconcile its segregated bank accounts as often as necessary but at least once every month. Some regulated entities need to reconcile segregated accounts daily if the volume of business is high.

## **NO CLIENT ASSETS**

68. The auditor must be alert to a situation where a licensed corporation is not permitted under its licensing condition to hold client assets or does not, as a matter of policy, hold client assets. Where this is the case, the licensed corporation would have systems in place to avoid receiving and holding client assets.

69. Although the auditor is not required to give the SFC independent assurance that the licensed corporation has not administered or held client assets, it still considers carrying out the following procedures:
- a. enquire as to what arrangements a licensed corporation has in place to ensure that relevant staff are aware of what constitutes client assets. This could be documented in a procedural manual or internal memorandum and would outline the procedures to be followed if client assets are identified;
  - b. enquire as to how settlements are effected on behalf of clients (reference will be made to client documentation and payment instructions on contract notes or statements);
  - c. review the cash book in order to confirm that receipts and payments in the cash book only relate to the licensed corporation's own money and that no client money is being received or held;
  - d. review the licensed corporation's client files to see whether they provide any indication that it has held client assets in order to undertake a particular transaction;
  - e. review client agreements for statements of how custody is to be operated; as a corollary, review the agreements with any custodians used and the counterparty files (i.e. the documentation which supports the securities transactions) for correspondence on settlement procedures to ensure that there is no evidence that the licensed corporation has offered client money protection (i.e. held separately in accordance with the rules);
  - f. ascertain whether a system of review exists to ensure that client assets are not administered or held. This could constitute periodic review by the internal auditor or compliance officer and encompasses substantive review of the licensed corporation's bank accounts and client agreements; and
  - g. enquire as to details of any client money the licensed corporation has received and the action taken.
70. The auditor will consider obtaining written representations from management that the licensed corporation has not breached any rules relating to the client assets during the period under review.