



30 October 2014

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

INVITATION TO COMMENT ON EXPOSURE DRAFT PRACTICE NOTES

- **ED Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries***
- **ED Practice Note 830 (Revised) *Reports by the Auditor under the Banking Ordinance***
- **ED Practice Note 860.1 (Revised) *The Audit of Retirement Schemes***

Comments to be received by 1 December 2014

The Hong Kong Institute of Certified Public Accountants' (Institute) Auditing and Assurance Standards Committee is seeking comments on the EDs which have 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 to update the relevant auditing and assurance pronouncements for the new Hong Kong Companies Ordinance (Cap. 622) ("new CO"). As part of the project, the proposed Practice Note ("PN") 820 (Revised), PN 830 (Revised) and PN 860.1 (Revised) have been updated to align with the requirements of the new CO.

Other than the changes for alignment with the new CO, there are other housekeeping changes made to PN 820 (Revised) which are set out below:

- (a) Added definition of "reportable matter" under the Securities and Futures Ordinance;
- (b) Updated the guidance on Money Laundering and Terrorist Financing;
- (c) Simplified the list of factors to be considered when assessing inherent risk of material misstatement;
- (d) Updated "Example 1 – auditor's report on financial statements – regulated entity" in Appendix 1;
- (e) Added guidance for cessation audits in Note 2 of "Example 2 – compliance report by the auditor – licensed corporation" in Appendix 1; and
- (f) Other housekeeping changes.

In order for readers to easily identify all the proposed changes, a marked-up version accompanies a clean version of the ED.

Comments on the proposed changes should be supported by specific reasoning and should be submitted in written form. To allow your comments on the EDs to be considered, comments are requested by the due date shown above.



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

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

Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Hong Kong

Fax number (+852) 2865 6776

E-mail: commentletters@hkipa.org.hk

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

30 October 2014
Exposure Draft

Response Due Date
1 December 2014

ED of PN 820 (Revised)

The Audit of Licensed Corporations and Associated Entities of Intermediaries



Hong Kong Institute of
Certified Public Accountants
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ED of PN 820 (Revised) *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
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The changes with respect to the Companies Ordinance (Cap.622) are effective for financial statements which cover a period beginning on or after 3 March 2014
All other changes are effective upon issue

Practice Note 820 (Revised)

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 (REVISED)
THE AUDIT OF LICENSED CORPORATIONS AND
ASSOCIATED ENTITIES OF INTERMEDIARIES**

(Issued [] 2014

The changes with respect to the Companies Ordinance (Cap.622) are effective for financial statements which cover a period beginning on or after 3 March 2014. All other changes are effective upon issue.

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**PRACTICE NOTE
820 (REVISED)
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 [] 2014, and the subsidiary legislation, codes and guidelines issued by the SFC up to [] 2014. 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*
- As prescribed in Schedule 5 of the SFO.
- n. *Regulated entity*
- A licensed corporation or an associated entity of an intermediary.
- o. *Reportable matter*
- A matter that in the opinion of the person acting as an auditor within the meaning of section 157(1)(a) of the SFO –
- (a) in the case of a licensed corporation –
 - (i) constitutes on the part of the licensed corporation or any of its associated entities a failure to comply with any prescribed requirement;
 - (ii) adversely affects to a material extent the financial position of the licensed corporation or any of its associated entities; or
 - (iii) constitutes on the part of the licensed corporation a failure to comply with section 146 or with all or any of the requirements of the financial resources rules that apply to it; or
 - (b) in the case of an associated entity of an intermediary –
 - (i) constitutes on the part of the associated entity a failure to comply with any prescribed requirement; or
 - (ii) where the associated entity is not an authorized financial institution, adversely affects to a material extent the financial position of the associated entity.
- p. *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.
- q. *SFC*
- Securities and Futures Commission.
- r. *SFO*
- Securities and Futures Ordinance.
- s. *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.
- t. *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 different types of regulated activities as prescribed in Schedule 5 of the SFO.

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.
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) in a prescribed manner.

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 minimum 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 his 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 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 is 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 by the auditor from management in such circumstances.

Money Laundering and Terrorist Financing

- 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 and terrorist financing activities.

36. The primary bodies of law in Hong Kong concerned with the subject of money laundering and terrorist financing are the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, 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 an Anti-Money Laundering Bulletin (AMLB) 1 on "Requirements on Anti-money Laundering, Anti-terrorist Financing and Related matters" and in May 2012 a supplement to AMLB 1, "Frequently Asked Questions on Suspicious Transaction Reporting".
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 high level controls 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 to include in the management letter to directors or management 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 his 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 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 client 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;
 - d. the risk profile of business undertaken, the complexity and consistency of products, methods and operations in different departments or locations;
 - e. client profile (retail vs. institutional);
 - f. existence of claims and complaints by clients;
 - g. the legal and operational structure of the regulated entities, the number of branches or sales offices (see paragraph 57 below);
 - h. where a group structure exists, the financial and managerial support provided to and by other group companies;
 - i. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
 - j. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;
 - k. the recruitment, competence, training and supervision of personnel (e.g. the use of licensed representatives); and
 - l. the integrity, competence and experience of management.
55. Regulated entities vary greatly in the complexity of their operations and hence the auditor may consider whether to take a reliance approach on the internal controls of the regulated entities. Attention should be paid 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.

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 regulated entity'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 regulated entity. 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 regulated entity's system of control over client assets are inadequate or decides that no reliance would be placed on the regulated entity'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 to this Practice Note. Fund tracing means obtaining copies of sampled outward cheques issued by the regulated entity from the bank or copies of cheques deposited into the bank account of the regulated entity and verifying the identity of the payee or drawer against the regulated entity'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 consequential 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 regulated entity 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 discrepancies between the FRR first 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 such as reviewing of reports issued in accordance with Hong Kong Standard on Assurance Engagements 3402 "Assurance Reports on Controls at a Service Organization" or other relevant service provider reports where available;
 - 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.

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 financial year 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 financial year 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 below, 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;

REPORTING RESPONSIBILITY OF AUDITORS UNDER THE BANKING ORDINANCE

- c. 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. 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. 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. assets are safeguarded and liabilities are 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 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, 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 in relation to a regulated entity 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 FAQs 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 financial year 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 financial year 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 a true and fair audit opinion 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 the compliance reporting engagement has been conducted in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 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 financial year 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 requirements 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:

For a licensed corporation

- a. explain, and reflect the financial position and operation of, such businesses;
- b. enable profit and loss accounts and balance sheets¹ 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.

For 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.

¹ 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 to 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:
- 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 above 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. 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.

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

107. There are essentially two aspects to the auditor's reporting responsibilities for client assets:
- a. whether during the financial year 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 financial year 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 compliance 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), the form and content of the report should comply with the requirements of HKSAE 3000. Section 157(1)(b) of the SFO, requires the auditor, 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.

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 state the fact where there are no such circumstances.

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 417 of the Companies Ordinance states that a person may resign from the office of auditor by giving the company a notice in writing that is accompanied by a statement required to be given under section 424. Section 424 states that a person who resigns from office must on the resignation, give the company (a) if the person considers that there are circumstances connected with the resignation that should be brought to the attention of the company's members or creditors, a statement of those circumstances; or (b) if the person considers that there are no such circumstances, a statement to that effect. Section 425(1) requires the same statement to be given where the auditor retires or is removed from office except for the conditions as stated in 425(3). 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 the regulated entity in question 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 MEMBERS OF ABC SECURITIES LIMITED

(incorporated in Hong Kong with limited liability)¹

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 statement of financial position as at 31 December 20X1,² and [the statement of profit or loss and] ³ the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows 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 audit⁴. 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

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

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.

³ HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

⁴ 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".

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.

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 financial position of the Company as at 31 December 20X1, and of its financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in compliance 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 Ordinance⁵

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

⁵ For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 "Modifications to the Opinion in the Independent Auditor's Report", Appendix, Illustrations 3, 4 and 5.

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]² 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)² 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.¹ 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.¹ sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
 - iii.¹ 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.]¹

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)² of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] from the records of the company;
 - b.¹ 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. 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.¹ sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
 - iii.¹ 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

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. In addition, the reference to "section 3(1)(b)" of the Hong Kong Securities and Futures (Accounts and Audit) Rules in this example report should be changed to "section 3(2)(b)" instead.

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]² 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.¹ 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.¹ 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 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.

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.¹ 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
 - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.
- 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.¹ 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

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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year under review.

PN 820 (Revised)
Issued [] 2014 February 2004; revised December 2010

The changes with respect to the Companies Ordinance (Cap.622) are effective for financial statements which cover a period beginning on or after 3 March 2014
All other changes are effective upon issue

Practice Note 820 (Revised)

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 (REVISED)
THE AUDIT OF LICENSED CORPORATIONS AND
ASSOCIATED ENTITIES OF INTERMEDIARIES

*(Issued [] 2014 February 2004; revised September 2004 (name change), revised March 2008
and revised December 2010*

*The changes with respect to the Companies Ordinance (Cap.622) are effective for financial
statements which cover a period beginning on or after 3 March 2014. All other changes are effective
upon issue.*

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APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS

APPENDIX 2 - CLIENT ASSETS

PRACTICE NOTE
820 (REVISED)
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~~] 2014, and the subsidiary legislation, codes and guidelines issued by the SFC up to [~~1 August 2007~~] 2014. 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*

~~As prescribed in Schedule 5 of the SFO. 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. *Reportable matter*

A matter that in the opinion of the person acting as an auditor within the meaning of section 157(1)(a) of the SFO –

(a) in the case of a licensed corporation –

- (i) constitutes on the part of the licensed corporation or any of its associated entities a failure to comply with any prescribed requirement;
- (ii) adversely affects to a material extent the financial position of the licensed corporation or any of its associated entities; or
- (iii) constitutes on the part of the licensed corporation a failure to comply with section 146 or with all or any of the requirements of the financial resources rules that apply to it; or

(b) in the case of an associated entity of an intermediary –

- (i) constitutes on the part of the associated entity a failure to comply with any prescribed requirement; or
- (ii) where the associated entity is not an authorized financial institution, adversely affects to a material extent the financial position of the associated entity.

o-p. *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.

oq. *SFC*

Securities and Futures Commission.

or. *SFO*

Securities and Futures Ordinance.

os. *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.

ot. *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 different types~~ of regulated activities: as prescribed in Schedule 5 of the SFO.

~~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) in a prescribed manner ~~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 minimum~~ 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~~his 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~~is 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 by the auditor from management in such circumstances.

Money Laundering and Terrorist Financing

- 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 and terrorist financing activities.

36. The primary bodies of law in Hong Kong concerned with the subject of money laundering and terrorist financing are the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, 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 an Legal Anti-Money Laundering Bulletin (AMLB) 1 on "Requirements on Anti-money Laundering, Anti-terrorist Financing and Related matters" and in May 2012 a supplement to AMLB 1, "Frequently Asked Questions on Suspicious Transaction Reporting".
37. The SFC expects regulated entities to establish policies and controls to combat money laundering and terrorist financing which cover the following areas:
- the establishment and maintenance of policies, procedures and controls to deter and to recognize suspicious transactions;
 - the establishment of a procedure to report suspicious transactions;
 - evidence of client identification;
 - retention of client identification and transaction records for use as evidence in future investigations; and
 - 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:
- give rise to claims by investors against the regulated entity; and
 - 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-controls 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:
- 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.
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 cCodes and gGuidelines 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 the management letter to directors or management, ~~as a matter of course,~~ as a matter of course, a statement that:
- the management letter has been prepared for the sole use of the regulated entities;
 - 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~~ his 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);~~
 - ed. the risk profile of business undertaken, the complexity and consistency of products, methods and operations in different departments or locations;
 - fe. client profile (retail vs. institutional);
 - gf. 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;~~
 - kg. the legal and operational structure of the regulated entities, the number of branches or sales offices (see paragraph 57 below);
 - kh. 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;~~
 - nj. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
 - oj. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;

- p.k. the recruitment, competence, training and supervision of personnel (e.g. the use of licensed representatives); and
- q.l. the integrity, competence and experience of management.
55. Regulated entities vary greatly in the complexity of their operations and hence ~~in the level of reliance which the auditor may place on their detailed~~ the auditor may consider whether to take a reliance approach on the internal controls of the regulated entities. ~~These are particularly important.~~ Attention should be paid 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 cCompliance rReport (see paragraphs 107 to 110). Any shortfall in client assets, whether due to misappropriation or otherwise, may have significant implications on the ~~licensed corporation~~ regulated entity'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~~ regulated entity. 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~~ regulated entity's system of control over client assets are inadequate or decides that no reliance would be placed on the ~~licensed corporation~~ regulated entity'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 to this Practice Note. Fund tracing means obtaining copies of sampled outward cheques issued by the ~~licensed corporation~~ regulated entity from the bank or copies of cheques deposited into the bank account of the ~~licensed corporation~~ regulated entity and verifying the identity of the payee or drawer against the ~~licensed corporation~~ regulated entity'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 consequential 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~~ regulated entity will require an auditor to make the same professional judgment decisions as on any audit with reference to the ~~S~~standard. However the auditor would remember that in respect of the ~~c~~Compliance ~~r~~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 ~~r~~Rules then that breach needs to be reported in the ~~c~~Compliance ~~r~~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~~ discrepancies between the FRR first submitted and the financial statements and therefore it is possible to have a reconciliation reported in the ~~c~~Compliance ~~r~~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 such as~~ 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 where available;~~
 - 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 financial year 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 financial year 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 below, 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~~ 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 ~~L~~icensed ~~C~~orporations only);
 - d. to prepare Analysis of Client Assets (for ~~A~~ssociated ~~E~~ntity 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 are 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~~ 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 in relation to a regulated entity 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 AFAQs 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 financial year 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 financial year 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 true and fair 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 RReport by the auditor

87. The ~~c~~Compliance RReport setting out the auditor's conclusions on matters set out in paragraph 79 should be addressed to the directors of the regulated entity:
- For a licensed corporation, an example ~~c~~Compliance RReport is given in Example 2 of Appendix 1 to this Practice Note.
 - For an associated entity of an intermediary, an example ~~c~~Compliance RReport 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 ~~has been conducted~~ in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 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 ~~c~~Compliance RReport is dated with the same date as the auditor's report on the financial statements.

Guidance on the reporting requirements of the Compliance RReport

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 financial year 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~~ requirements 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:

For a licensed corporation

- a. explain, and reflect the financial position and operation of, such businesses;
- b. enable profit and loss accounts and balance sheets¹ 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.

For 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.

¹ 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~~ to 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 year²:
- 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 above 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.

² See Paragraph 106 for the exceptions.

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

107. There are essentially two aspects to the auditor's reporting responsibilities for client assets:
- a. whether during the financial year~~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 financial year~~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 cCompliance rR~~e~~port. 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 cCompliance rR~~e~~port. 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 R~~e~~***ports***

111. The auditor may qualify its cCompliance rR~~e~~port 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 cCompliance rR~~e~~port.
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 cCompliance rR~~e~~port (or its report on the financial statements), the form and content of the report should comply with the requirements of HKSAE 3000. ~~it is required under s~~Section 157(1)(b) of the SFO, requires the auditor, 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~~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 state the fact 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 cCompliance rReport.

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 240A(2)417~~ of the Companies Ordinance states that a person may resign from the office of auditor by giving the company a notice in writing that is accompanied by a statement required to be given under section 424. Section 424 states that a person who resigns from office must on the resignation, give the company (a) if the person considers that there are circumstances connected with the resignation that should be brought to the attention of the company's members or creditors, a statement of those circumstances; or (b) if the person considers that there are no such circumstances, a statement to that effect~~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. Section 425(1) requires the same statement to be given where the auditor retires or is removed from office except for the conditions as stated in 425(3).~~ 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 cCompliance rReport 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 cCompliance rReport 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~~ the regulated entity in question 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~~ MEMBERS OF ABC SECURITIES LIMITED

(incorporated in Hong Kong with limited liability)¹

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 position² as at 31 December 20X1,³ and ~~[the income statement of profit or loss and]~~ the statement of profit or loss and other comprehensive income², statement of changes in equity and ~~cash flow statement~~ statement of cash flows² 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 audit⁵. 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

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

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

³ 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.

⁴ HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

⁵ 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".

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.

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 financial position~~ of the Company's ~~affairs~~ as at 31 December 20X1, and of its ~~[profit]~~~~[loss]~~ financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in ~~accordance~~ compliance 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 Ordinance⁶

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

⁶ For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 "Modifications to the Opinion in the Independent Auditor's Report", Appendix, Illustrations 3, 4 and 5.

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*]² 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)² 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.¹ 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.¹ sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
 - iii.¹ 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.]¹

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)² of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] from the records of the company;
 - b.¹ 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. 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.¹ sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
 - iii.¹ 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

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. In addition, the reference to "section 3(1)(b)" of the Hong Kong Securities and Futures (Accounts and Audit) Rules in this example report should be changed to "section 3(2)(b)" instead.

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*]² 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.¹ 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.¹ 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 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.

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.¹ 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.¹ 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

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 financial year~~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 financial year~~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 financial year~~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 financial year~~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 financial year~~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 financial year~~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 financial year 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 financial year 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 financial year 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 financial year~~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 financial year~~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 financial year~~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 financial year~~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 financial year~~period~~ under review.

30 October 2014
Exposure Draft

Response Due Date
1 December 2014

ED of PN 830 (Revised)

Reports by the Auditor under the Banking Ordinance



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

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ED of PN 830 (Revised) *Reports by the Auditor under the Banking Ordinance*

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

PN 830 (Revised)
Issued [] 2014

Effective for financial statements which cover a period
beginning on or after 3 March 2014
Early application is not permitted

Practice Note 830 (Revised)

Reports by the Auditor under the Banking Ordinance



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

PRACTICE NOTE 830 (REVISED)

REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE

(Issued [] 2014; *Effective for financial statements which cover a period beginning on or after 3 March 2014.*
Early application is not permitted)

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PART I – INTRODUCTION

1. In this Practice Note (“PN”) all the sections mentioned below are in respect of the Banking Ordinance (“Ordinance”) unless otherwise stated.
2. The purpose of this PN is to assist the auditor of authorized institutions (“AIs”) in reporting under the Ordinance.
3. This PN provides guidance to members on the reporting responsibilities of the auditor appointed for the purposes of sections 50(1)(c), 59(2), 63(3) and 63(3A). Guidance is also provided on other reports and notifications issued by the auditor, including notification of audit qualifications or adverse statements under section 59A(2)(c), reporting of significant adverse matters and non-compliances under sections 63A and 63B, notification of resignation of the auditor under section 59A(2) and report of factual findings in relation to voluntary revocation of authorization of an AI. These are dealt with in Part II.
4. Guidance on auditor’s ad hoc communications with the Hong Kong Monetary Authority (“HKMA”) under the protection of section 61 is set out in Part III.
5. This PN is not intended to provide detailed guidance on the general audit procedures to be adopted in respect of the audit of the financial statements of an AI and does not apply to other reports provided by the auditor, such as those provided under the Companies Ordinance on financial statements. Guidance on auditor’s report on financial statements is set out in HKSA 700, “Forming an Opinion and Reporting on Financial Statements” and Practice Note 600.1 (Revised) “Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)”.
6. In addition to the reporting responsibilities under the Ordinance, the auditor is required to report to the relevant authorities in accordance with the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance for the purpose of combating money laundering and terrorism. This PN does not provide guidance in this regard.
7. This PN also contains in Appendix 5 a guide to the relevant provisions for the auditor in the Ordinance which were effective as at 31 October 2004. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this PN should be used in conjunction with the legislation.
8. It should be borne in mind that certain expressions used in the Ordinance may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this PN, members will wish to seek legal advice.
9. The term Monetary Authority in the Ordinance refers to a person appointed by the Financial Secretary under the Exchange Fund Ordinance. The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability and is headed by the Monetary Authority. In this PN, the term “HKMA” is used generally to refer to the organization as a whole. The term “Monetary Authority” is used when quoting a specific reference from the Ordinance and in the auditor’s reports under the Ordinance.
10. The PN has been prepared in consultation with the HKMA.

PART II – AUDITOR’S REPORTING RESPONSIBILITIES UNDER THE ORDINANCE

Introduction

11. The auditor is normally appointed by the AI with the approval of the HKMA for the purpose of preparing certain reports under the Ordinance. The Ordinance generally recognizes the auditor as a person appointed by the shareholders of a locally incorporated AI under the Companies Ordinance to report on whether the AI’s financial statements give a true and fair view (“statutory auditor”) or those appointed by the AI to submit a report to the HKMA under section 59(2), 63(3) or 63(3A). Submission of reports by the auditor under the Ordinance (except reporting under section 59(2)) is normally carried out by an AI’s statutory auditor although the HKMA has the right to commission reports from another audit firm where:
- a. such an arrangement can better utilize the knowledge and expertise of different auditor which may be beneficial to the AI; or
 - b. the HKMA has reason to believe that the statutory auditor would not be capable of producing an adequate report, after taking into account:
 - the reputation of the statutory auditor;
 - the quality of reports previously submitted to the HKMA by the statutory auditor;
 - the expertise, knowledge and resources of the statutory auditor; and
 - any potential conflict of interest on the part of the statutory auditor.

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

12. The auditor has a number of reporting responsibilities under the Ordinance. These include:
- a. Regular reports
 - Reporting on specified banking returns (section 63(3)) (see paragraphs 38 to 65 below);
 - Reporting on systems of control over the compilation of banking returns, compliance with specified sections of the Ordinance and maintenance of adequate provision (section 63(3A)) (see paragraphs 66 to 102 below).
 - b. Other reports
 - Ad hoc reporting on internal controls, specific transactions or any other matters (section 59(2)) (see paragraphs 103 to 125 below);
 - Notification of audit qualifications or adverse statements in audit reports on AI’s financial statements (section 59A(2)(c)) (see paragraphs 126 to 128 below);
 - Reporting of significant adverse matters and non-compliances (sections 63A and 63B) (see paragraphs 129 to 137 below);
 - Notification of resignation of the auditor (section 59A(2)) (see paragraph 138 below).
 - c. Under section 50(1)(c), locally incorporated AIs which maintain an overseas branch may need to appoint an auditor, if the HKMA so requires, to report on whether a return or information submitted by them in respect of their overseas branch(es) is correctly compiled, in all material respects, from the books and records of the branch(es).

13. The auditor is also normally requested to furnish a report on voluntary revocation of an AI's authorization to the HKMA in respect of the balance sheet¹, third party deposit liabilities, contingent liabilities and outstanding commitments (see paragraphs 139 to 144 below).
14. The HKMA issues specific completion instructions and guidelines to AIs on the compilation of banking returns and on meeting the provisions of the Ordinance. In its Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance", the HKMA also provides a description of the nature of some of the controls and procedures it expects AIs to have in place to demonstrate adequate controls over compilation of banking returns and compliance with the provisions in the Ordinance. The auditor would have regard to the requirements set out in Supervisory Policy Manual IC-3 in fulfilling the reporting responsibilities under the Ordinance.

General guidance

Types of engagements under the Ordinance

15. The auditor's reporting responsibilities under the Ordinance can generally be categorized as either reasonable assurance engagements, limited assurance engagements, or agreed-upon procedures engagements.
16. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.
17. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.
18. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed, and to report on factual findings. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report would assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

Overview of the reporting process

19. The following are action steps that the auditor would consider in order to discharge the reporting responsibilities under the Ordinance:

- a. *Scoping and planning*

For reporting under section 63(3) and (3A):

- Assemble the engagement team including any necessary specialists;
- Obtain from the AI the terms of reference (normally called a "Letter of Instruction") identifying the banking returns or systems of control to be reported on and the period to be covered;
- Issue a letter of engagement;
- Obtain the relevant banking returns to be reported on from the AI (if applicable);
- Undertake detailed planning and fieldwork.

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

For reporting under section 59(2):

- Obtain the draft scope of review prepared by the HKMA and discuss the nature of the appointment with the AI;
- Seek a meeting with the HKMA (at which representatives of the AI would normally be present) to obtain the background information, including the reasons why the HKMA is requesting the report;
- Where necessary, hold scoping meeting(s) with the HKMA and the AI to further refine the scope;
- Agree the scope and all other matters that are to be recorded in the Letter of Instruction with the AI and the HKMA;
- Obtain from the AI the Letter of Instruction;
- Issue a letter of engagement to the AI, incorporating the Letter of Instruction;
- Undertake detailed planning and fieldwork.

b. Execution

- If requested by the HKMA, or if considered necessary as a result of issues identified whilst conducting the work, arrange discussions or meetings with the HKMA and/or the AI;
- Incorporate the responses of management (obtained in writing) of the AI to the findings in the final report (if this is the agreed means of communicating management's comments to the HKMA);
- For engagements under section 59(2), arrange with the AI and the HKMA to amend or reissue the Letter of Instruction to reflect any significant matters that come to light during the performance of the work and any changes in scope verbally communicated to the AI or the auditor (if necessary).

c. Finalization and reporting

- Finalize the report with the AI's management comments or responses included, where appropriate;
- Obtain a management representation letter from the AI;
- Issue the final report to the AI for submission to the HKMA;
- For reports under section 59(2), if comments from the AI's management on the draft final report were not incorporated into the auditor's report, obtain a copy of the comments sent by the AI to the HKMA;
- Prepare for and attend any tripartite meeting to discuss the report findings (if necessary).

20. The scope of an engagement under section 63(3) or (3A) is normally considered to be relatively routine and standardized and therefore, some of the above action steps may have been addressed previously and can be carried over into the current period engagement.

Engagement acceptance

21. When undertaking an engagement to provide a report under the Ordinance, the auditor would recognize that throughout the process, there are two parties interested in the report - the AI which engages the auditor; and the HKMA, which has required the AI to commission the report. The auditor would manage the expectations of both parties to reduce the risk of misunderstanding.
22. The auditor would ensure that the scope of the engagement is clear, so that the HKMA and the AI agree, accept and understand the areas to be examined, the form of reporting of the overall findings, the content and structure of the report to be provided and the type and extent of procedures to be undertaken. However, it is the responsibility of the HKMA to determine whether the scope of the work specified in the Letter of Instruction is sufficient for its purposes.
23. For reporting under section 59(2), the HKMA recognizes that normally there will be value in holding discussions involving the auditor concerning the proposed assignment in a tripartite meeting (between the AI, the HKMA and the auditor) or, in less usual circumstances, a bilateral meeting (between the HKMA and the auditor only) but is not bound to do so. This discussion can occur when a draft scope has already been prepared by the HKMA and this would form the basis for the discussion.
24. When approached to undertake an engagement to report under the Ordinance and during the discussion of the scope, the auditor would consider the professional skills required to undertake the engagement.
25. In particular, the auditor would need to have knowledge and understanding of the HKMA's regulatory requirements and the statutory provisions relevant to the scope of the engagement. This is necessary in order to understand and evaluate the scope of the engagement at the outset, and to determine the manner in which the findings in the auditor's report would be presented. In addition, the auditor is required to report, in certain circumstances and without delay, direct to the HKMA and therefore would need to be aware of the relevant provisions.
26. The auditor would need to consider whether previous or existing professional relationships could present a conflict of interest in accepting the engagement. If the auditor becomes aware of relationships with the AI which could be construed as a conflict of interest, the auditor would advise the AI and the HKMA of this issue and all parties have to be satisfied that the auditor is appropriately placed to undertake the assignment objectively.
27. The HKMA has indicated that it would take into account the knowledge and expertise of the statutory auditor and the need for a fresh perspective on matters to be examined when deciding whether to nominate or approve the appointment of the statutory auditor or another audit firm.
28. The auditor and the AI would agree on the terms of the engagement, which would be recorded in an engagement letter or other suitable form of written contract. The auditor would follow the guidance set out in HKSA 210, "Agreeing the Terms of Audit Engagements" and agree the terms of the engagement in relation to the auditor's work performed under the Ordinance.
29. Examples of engagement letters are set out in Appendix 3 to this PN.

Reporting considerations

30. Generally, when making a report, the auditor would apply techniques to keep narrative in the report clear, logically structured and concise, such as using bullet points and tables, and relegating detailed elements to the detailed sections and appendices to the report. The auditor would include specific findings such as exceptions, deficiencies, observations or required recommendations (however defined) arising from the work undertaken together with sufficient background information for the HKMA and the AI to understand the context in which the findings are made and their implications.

31. The auditor would need to be aware that specific findings included in the report can form the basis of supervisory or enforcement action by the HKMA. Therefore, it is important that all relevant matters, which are considered material in the circumstances, be included in the report. When evaluating whether and how to report a specific finding, the auditor would need to recognize that materiality for reporting under the Ordinance may be different to that used in the context of an audit of the financial statements of the AI or an assignment undertaken solely for the AI's management. The auditor would take into account the HKMA's interests in its role as a supervisor, for example by considering the findings in the context of: the HKMA's supervisory objectives; requirements set out in the HKMA's Supervisory Policy Manual in relation to the area examined; and the HKMA's reasons for commissioning a report, including any concerns or issues raised during the scoping discussions. It may also be useful for the auditor to discuss and agree with the HKMA and the AI on the materiality threshold so that what would constitute a matter to be reported as a specific finding and how it will be described are clearly understood between all parties.
32. The materiality threshold is a matter of professional judgment but, unless otherwise agreed with the HKMA, the auditor would normally report all relevant matters other than those considered to be immaterial. This PN provides further guidance for the auditor on materiality for the purpose of the reporting responsibilities under the Ordinance (see paragraphs 60, 93 to 97 and 118 to 119 below for different engagements).
33. Unless otherwise agreed with the HKMA, where an auditor's engagement for the purpose of reporting under the Ordinance includes the examination of controls over a specified period or transactions during that period, the auditor would include all material findings identified even if the findings identified were corrected during or after the period examined.
34. The auditor would seek management's confirmation of the factual accuracy of information or statements contained in the auditor's report. This may be achieved either by way of a written confirmation from management or as a specific representation from management included in the management representation letter. Examples of management representation letters are set out in Appendix 2 to this PN.

Obtaining management comments

35. The HKMA expects management of the AI to have the opportunity to provide written comments on the auditor's report prior to its submission to the HKMA. Management may wish to provide the auditor with written comments for incorporation into the auditor's report prior to its issue. Alternatively, management of the AI may choose to provide written comments directly to the HKMA when the AI submits the report to the HKMA.
36. Where the auditor includes management comments in the report prior to its issue, the report would clearly identify the comments of management. The report would also state clearly that the management of the AI is responsible for the accuracy of the comments made, that the auditor takes no responsibility for them and that they are not covered by the auditor's conclusion (or overall findings otherwise provided). A common practice used in the presentation of management letters or internal control reports, which can assist the review of an auditor's report by the HKMA, is to incorporate management comments in the body of the report, against the elements of the report to which the comments relate.
37. Management comments for incorporation in the auditor's report prior to issue would be obtained from, or confirmed in writing by, the AI in order to minimize the risk of error or misunderstanding. Where the auditor issues a report without incorporating management's comments, the auditor would obtain a copy of any comments that management submits directly to the HKMA.

Auditor's report under section 63(3)

General

38. Management of AIs is required by the HKMA to submit a number of returns within an integrated banking statistics system. The HKMA may also require an AI to submit a report, prepared by the auditor, as to whether or not, in the opinion of the auditor, a return submitted to the HKMA is correctly compiled, in all material respects, from the books and records of the AI and, if not so correctly compiled, the nature and extent of the incorrectness. General guidance on the auditor's report on banking returns is provided in the HKMA's Supervisory Policy Manual IC-3.
39. Preparation and submission of the banking returns is the responsibility of the AI's management. The Ordinance makes it an offence for any person who signs any document for the purposes of section 63 which is known or ought to be known to be false in a material particular. Under section 123, it is also an offence for directors, chief executives, managers, trustees, employees and agents of an AI to wilfully deceive by falsifying books and records.
40. The HKMA has emphasized the importance of the banking returns submitted by AIs and can exercise the powers derived from section 63(3) (and section 50(1)(c)) to require AIs to appoint an auditor to examine and report upon the banking returns submitted to the HKMA and any other returns which are used for prudential purposes to enable or assist the HKMA to exercise its duties and functions under the Ordinance. On occasion, the HKMA may require information in addition to the information contained in standard returns. Such information could also fall within the scope of information to be reported upon by the auditor if it is requested by the HKMA under section 63(2).
41. These reporting arrangements are intended to reassure the HKMA about the reliability of the information received from an AI. It will be for the HKMA to determine, in the light of all the information available to it, the type of action, if any, that would be taken for its prudential supervision purposes.

Scope

42. The work that the auditor performs for the purpose of reporting under section 63(3) is a reasonable assurance engagement. The responsibility for correct compilation of returns rests with the management of the AI and the auditor's responsibility is to report on whether the AI's returns are correctly compiled, in all material respects, from the books and records of the AI based on procedures the auditor performed. Reference should be made to Hong Kong Standard on Assurance Engagements (HKSAE) 3000, "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" for details of the standards and guidance on reasonable assurance engagements.
43. Under section 63(3), the HKMA can require particular returns to be reported on by the auditor. It should also be noted that for certain returns, the auditor would normally report only on specified parts of the return. For a locally incorporated AI, the auditor would normally be required to report on:
 - Return of Capital Adequacy Ratio (All parts);
 - Return of Large Exposures (Parts I, II and III, columns 1 – 5);
 - Return of Liquidity Position (Part I); and
 - Certificate of compliance with the Ordinance (Parts I – III).

Overseas incorporated AIs operate in the form of a branch in Hong Kong are not required to maintain a minimum capital adequacy ratio in respect of the branch. Accordingly, the auditor would normally be required to report on:

- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part I); and
- Certificate of compliance with the Ordinance.

The HKMA can require a report on any return or other information submitted to it under section 63(1) and (2) (and section 50(1)(a) and (b)).

44. The returns to be reported on are normally the most comprehensive in the series. That is, where an AI completes a consolidated return, it will be that return which would be reported on. Where it has no subsidiaries, but has overseas branches, it will be the combined return that would be reported on. The HKMA normally selects only one date for the returns to be reported on per year, but may select other returns and dates if it believes the returns are not being completed properly. The date/period will not necessarily coincide with the end of the AI's financial year. The date will be determined by the HKMA retrospectively after the due submission date of the returns concerned.
45. When errors are identified in the returns submitted to the HKMA, AIs would, depending on materiality, make suitable amendments to the returns and re-submit these to the HKMA. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has indicated that the returns to be reported on by the auditor would be the returns originally submitted to the HKMA unless the HKMA specifies otherwise.

Nature of work

46. The work to be carried out for the purpose of reporting under section 63(3) involves agreeing amounts contained in the relevant returns to appropriate records maintained by the AI and checking whether the amounts have been properly compiled based on the completion instructions issued by the HKMA.
47. The auditor would review copies of the following documents when planning the work:
 - a. in respect of locally incorporated AIs, if it is not the statutory auditor, the latest audited financial statements of the AI together with a copy of the latest management letter issued by the statutory auditor where relevant. The auditor would also seek the AI's permission to discuss any matters relevant to the examination with the statutory auditor (for co-operation between auditors);
 - b. all correspondence and all minutes or notes of meetings that the AI has held with the HKMA which are relevant to the auditor's examination of the internal control systems in relation to relevant returns;
 - c. all board and management committee minutes;
 - d. the returns originally submitted to the HKMA or those which the HKMA has specified otherwise, together with any amendments submitted thereafter.

Testing

48. The nature of testing required will vary from AI to AI as this will be dependent on the nature of the systems and processes used to produce the necessary information for compilation of the returns (e.g. whether processes are automated or performed manually).
49. An engagement under section 63(3) requires the auditor to state whether, in the auditor's opinion, the returns have been correctly compiled, in all material respects, from the books and records of the AI. Accordingly, the work the auditor is expected to perform on specified returns normally involves agreeing relevant amounts in the returns to the AI's books and records and ensuring that the compilation procedures were performed in accordance with the completion instructions issued by the HKMA for the relevant returns.
50. The definition of books and records is not specifically set out in the Ordinance. However, the HKMA would expect the information contained in the returns to be consistent with the books and records of the AI. The auditor would consider books and records to include the general ledger (including sub ledgers) and records or reports produced by systems (e.g. loan processing systems) which contain or explain in more specific detail particular items in the

general ledger (e.g. exposures to specific counterparties or a breakdown of balances by maturity buckets) and other records which support particular items in the returns such as off-balance sheet exposures.

51. There is no requirement for the auditor to provide an opinion that the books and records are correct and complete but only that the amounts in the return agree with those books or records. It would normally be sufficient to check all items in the return to the working papers used by the AI to prepare the return and to check, on a sample basis, the compilation of the amounts contained in such working papers to the general ledger. For more detailed information reported in certain returns, it may be test checked to reports generated from established systems which reconcile to the general ledger.
52. In testing for completeness and accuracy, the auditor would also trace on a sample basis the extraction of information contained in the accounting and other records to the relevant returns. Any material adjustments made to the accounting and other records in the course of compiling the returns would be considered for reasonableness. The auditor would also examine the compilation procedures to ensure they are consistent in all material aspects with the HKMA's current completion instructions (including notes and definitions) and any further written rulings that apply specifically to the particular AI.
53. As the auditor's work normally involves testing items on a sample basis, the auditor would consider the adequacy of the compilation process adopted in the preparation of the relevant returns as part of the determination of the sample sizes. For example, the auditor would consider whether the definitions and interpretations used in compiling the information are appropriate, whether the controls are adequate to prevent and identify errors, and whether known issues are taken into account in the compilation process. The auditor would refer to HKSA 530, "Audit Sampling" for further guidance in this regard.
54. On occasion, different interpretations of a particular definition or the requirements of the completion instructions may give rise to different results being reported in the returns. This is important as definitions and requirements set out in the Ordinance and the HKMA's completion instructions are typically worded in a general fashion and management would need to determine how such definitions or requirements would be applied to specific businesses or processes of an AI. Where issues relating to interpretation of the requirements or definition arise, the auditor would consider the following procedures in order to determine whether appropriate interpretation has been adopted:
 - Obtain a detailed understanding of the facts and rationale supporting the interpretation adopted by the AI;
 - Review relevant definitions and interpretations contained in the Ordinance, relevant completion instructions and industry practices;
 - Request that the AI discusses the issue with relevant officials of the HKMA and seeks written clarification thereon which would include the rationale for any conclusions drawn;
 - Consider the need to confirm the interpretation directly with relevant officials of the HKMA;
 - Determine the need to include an appropriate description of the interpretation adopted to form the basis of the opinion within the auditor's report.
55. When evaluating the manner in which a specific finding would be reported, the auditor would take into account the requirements of guidelines issued by the HKMA.

General procedures

56. The general procedures which the auditor would carry out in respect of the work on the examination of returns for the purpose of reporting under section 63(3) include:
- Obtain an understanding of the purpose of the returns and the completion instructions for the relevant returns;
 - Review correspondence between the AI and the HKMA to determine whether specific treatments for reporting items in the returns were agreed and adopted by the AI and whether the HKMA has granted specific exemptions to certain requirements for the particular AI;
 - Ascertain whether the AI is required to prepare a consolidated return and, if so, determine the entities that are to be included by reviewing the relevant instructions or correspondence issued by the HKMA;
 - Test check the calculations on the returns;
 - Test check items from the returns to the working papers used by the AI to prepare the returns;
 - Test check balances from working papers used by the AI to books and records and vice versa;
 - Check that the compilation of amounts in the returns is in accordance with the relevant completion instructions and definitions;
 - Check whether only amounts which meet the relevant criteria are included in specific line items;
 - Reconcile totals to the general ledger where appropriate.

Procedures pertaining to specific returns

57. The auditor would ensure that appropriate procedures are designed and carried out to gain adequate assurance that the returns are compiled correctly from the books and records. The specific compilation procedures of each return would vary depending on the requirements of particular return as set out in the completion instructions and other guidelines issued by the HKMA. The auditor would perform tests on the compilation procedures to determine whether they meet the requirements of completion instructions and relevant guidelines issued by the HKMA. Particular areas which the auditor would take into consideration in examining returns which normally fall within the scope for reporting under section 63(3) are highlighted below for reference purposes:

a. Capital Adequacy

- Check that reserves have been appropriately classified under the categories of “Core capital” and “Supplementary capital”;
- Perform checks as to whether the amounts and nature of items recognized as “Supplementary capital” are in accordance with the limits and any specific guidance on criteria established by the HKMA in the completion instructions and in the HKMA’s Supervisory Policy Manual and other guidelines in respect of “Supplementary capital”;
- Perform checks as to whether the specified items are deducted from the core capital and supplementary capital in accordance with the completion instructions;

- Check that the AI has properly calculated the risk-weighted amount for credit risk, market risk and operational risk in relation to its on- and off-balance sheet exposures as the case requires, taking into account the type of instrument or exposure, the nature of counterparties, the maturity of the exposure and the approach it adopts to calculate the capital requirements for those exposures.

b. Large Exposures

- Obtain an understanding of how the AI captures and reports connected parties and transactions;
- Obtain a list of connected parties (as defined in the completion instructions) and perform procedures to ascertain completeness;
- Perform procedures to gain assurance that counterparties which are connected in a way that the financial soundness of one may affect the financial soundness of another are identified and that exposures to such counterparties are captured and aggregated for reporting purposes;
- Perform sample checks on individual exposure amounts to determine whether on- and off-balance sheet direct exposures are captured and whether indirect exposures (e.g. guarantees granted by the counterparty) are also appropriately identified and reported;
- Perform sample checks as to whether exposure amounts (aggregating all facilities) for individual counterparties or groups of counterparties have been captured on a daily basis and that the maximum exposure is identified from the daily reported exposures;
- Review the nature of counterparties or groups of counterparties and assess the appropriateness of classification within the relevant parts of the return.

c. Liquidity

- Perform sample checks as to whether various types of liquefiable assets and qualifying liabilities have been appropriately classified according to their nature, the remaining term to maturity, and that they qualify for inclusion as liquefiable assets and qualifying liabilities according to criteria set out in the Fourth Schedule of the Ordinance;
- Confirm with the AI whether the HKMA has given approval to the AI to calculate the average monthly liquidity ratio on the basis of specified days during the month and perform checks as to whether the AI calculates the ratio on the basis agreed with the HKMA;
- For the purpose of calculating the lowest liquidity ratio during the month, perform checks as to whether the AI determines the ratio as the lowest liquidity ratio recorded at the close of business on a working day, or specified day and the last calendar day of the month, as the case may be, during the month covered by the return.

d. Compliance

- Check that the capital base reported agrees to the amount reported in the Return of Capital Adequacy Ratio at the previous quarter end*;
- Perform checks on the collateral records maintained by the AI to determine whether the shares of the AI, its holding, subsidiary or fellow subsidiary companies are held as security for loans and other credit facilities;

- Perform checks on compliance with the requirements under sections 80, 81*, 83*, 85, 87*, 87A*, 88*, 90* and 106* during the reporting period;
- Obtain correspondence setting out the minimum capital adequacy and liquidity ratios set by the HKMA for the AI for the purpose of compliance with sections 98* and 102;
- For items 1-7 under Part III of the return, check that daily closing exposures were used in reporting the maximum exposure and that the amount reported excludes those items which were exempted under sections 81, 83, 87 and 88*;
- Check the calculations for the maximum ratio of pledged assets and ensure the amounts used were correctly extracted from the AI's register of charges or other appropriate books and records*;
- Review legal correspondence for civil proceedings which may have a material impact on the financial position of the AI and confirm with management that it has notified the HKMA of any such proceedings*.

** applicable for locally incorporated AIs only*

Representations by management

58. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management's responsibility for establishing and maintaining adequate accounting records and systems of control to ensure that the returns have been correctly compiled from the books and records of the AI and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that all the returns provided to the auditor for the purpose of this engagement are the ones first submitted to the HKMA;
 - c. stating that all transactions undertaken by the AI have been properly reflected and recorded in accounting and any other records and for the compilation of the returns, such records properly reflect the true nature of all transactions;
 - d. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondences with the HKMA, etc.) for the purpose of the auditor's examination of the returns, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
 - e. stating whether there have been any communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the information presented in the returns;
 - f. the returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the HKMA;
 - g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period;
 - h. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report; and

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

Materiality

60. The HKMA only requires errors which are material in amount or indicative of weaknesses in the compilation process to be reported. What constitutes material will need to be judged by the auditor on a case-by-case basis but the focus is on the quality of the statistics provided rather than on minor reporting errors. As a general rule the HKMA has stated in its Supervisory Policy Manual IC-3 that an error should normally be considered material if it exceeds 5% of the applicable item in the return to which it relates. It should also be noted that in addition to quantitative differences on a particular line item, the auditor would also consider the impact of errors in a particular line item on other parts of the return or on other returns subject to examination.

Reporting

61. Each error or exception considered to be material would be reported together with an appropriate description of the error as well as the impact on the relevant return. Such errors would include those identified by the auditor or amendments made by the AI subsequent to the submission of the return under examination.
62. Where exceptions are identified and there is evidence to suggest that weaknesses in internal controls exist, the auditor would also consider including in the report under section 63(3A) the observations and recommendations on the relevant internal controls for the HKMA and the AI to gain a fuller understanding of the implications of the auditor's findings (see paragraphs 98 to 102 below).
63. An identical copy of the returns on which the auditor's report is based would accompany the auditor's report. Errors or exceptions would be set out either within the body of the auditor's report or in an appendix, reference to which is made in the auditor's report.
64. The auditor should carry out a reasonable assurance engagement in accordance with HKSAE 3000 and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 and with reference to PN 830. The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within two months from the date of the notification from the HKMA and the AI would forward the auditor's report together with any comments thereon within a further one month. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.
65. Examples of auditor's reports under section 63(3) are set out in Appendix 1 to this PN – Examples 1 and 2.

Auditor's report under section 63(3A)

General

66. It is the responsibility of an AI's directors and management to ensure that adequate systems of internal control are maintained. It is the responsibility of the HKMA to judge whether an AI has maintained adequate systems of internal control as part of its overall assessment as to whether all the criteria for authorization are being met.
67. As a supervisor, the HKMA is concerned with obtaining evidence to enable it to form a view as to whether the prudential requirements on internal control systems are met. The HKMA will do this, inter alia, by considering any evidence provided by the auditor.
68. The HKMA has interpreted the requirements of the Ordinance in various modules of its Supervisory Policy Manual. The auditor would need to be familiar with the contents of the guidance contained in these modules of Supervisory Policy Manual to the extent relevant to the specific examination requested by the HKMA.
69. The HKMA will require AIs to appoint the auditor to report to the directors of a locally incorporated AI or the chief executive of a Hong Kong branch of an overseas incorporated AI whether, in the auditor's opinion, certain internal control systems have been maintained by the AI throughout the period examined in accordance with the requirements of the Ordinance. In forming the opinion, the auditor would have regard, inter alia, to the nature and scale of the business of the AI. The auditor will also be required, after forming an opinion on the specified internal control systems, to report on other matters contained in section 63(3A)(b).
70. An engagement to express an opinion on an AI's systems of control for the purpose of the Ordinance differs in purpose and in scope from a study and evaluation of the systems made as part of an audit of financial statements in order to express an opinion on whether those statements give a true and fair view. Given these differences, the auditor is unlikely to be able to rely solely on the work carried out for the purpose of auditing the financial statements and therefore the auditor would adopt additional procedures for the purpose of reporting under section 63(3A).
71. The scope and period to be covered by the report under section 63(3A) will normally be notified in writing to the AI and copied to the auditor.

Scope

72. The work that the auditor performs for the purpose of reporting under section 63(3A)(a) is an engagement providing reasonable assurance. The responsibility for adequate internal controls rests with the directors and management of the AI and the auditor's responsibility in providing reasonable assurance is to report on whether certain internal controls were in place during the relevant period. Having performed the work, the auditor is then required to report under section 63(3A)(b) on whether the auditor is aware of any material contraventions of certain provisions under the Ordinance by the AI and in addition, for locally incorporated AIs, any failure to maintain adequate provision. This assurance is based not only on the work performed under section 63(3A)(a) but would also take into account any other relevant information which comes to the attention of the auditor in the normal course of the audit work or in the examination of returns under section 63(3). The auditor will not, however, be expected to change the scope of the audit work nor the frequency or timing of the audit visits. Reference should be made to HKSAs 3000 for details on the standards and guidance in this regard.
73. The HKMA is empowered under section 63(3A)(a) to require an AI to submit a report by the auditor on whether, during a specified period, the internal control systems of the AI were adequate to enable, as much as is practicable:
 - a. the AI's returns or information to be correctly compiled, in all material respects, from the books and records of the AI;

- b. the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance;
 - c. in the case of a locally incorporated AI, the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
74. Having completed the work on the specified internal controls, the auditor would then report under section 63(3A)(b) in respect of the same period on whether:
- a. there appears to be any material contravention by the AI of any of its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance, and, if it so appears, the nature of the contravention and the evidence therefor; and
 - b. in the case of a locally incorporated AI, there appears to have been any failure by the AI to maintain adequate provision.
75. The period covered by a report under section 63(3A) will not normally be more than 12 months unless the HKMA is of the view that a longer period is necessary in the interest of depositors or the public. Usually the period covered will be the financial year. Only one report is required to be submitted under section 63(3A).

Nature of work

76. The nature of the work to be carried out will be to determine whether appropriate internal controls exist and test the effective functioning of such internal controls. Testing would, therefore, be designed to determine whether the control procedures are being performed effectively. It should also be noted that the adequacy of controls would be assessed with reference to Supervisory Policy Manual and guidelines issued by the HKMA and taking into account the nature of business and size of the operation of the AI. For example, if the control being tested was the application of appropriate provisioning levels, the tests of the control may include:
- enquiry of the relevant officer and the supervisor/reviewer to ensure they clearly understand the objective of performing the control procedure;
 - examination of the AI's provisioning policies, procedures and methodologies;
 - assessment of whether the process of determining the level of provision has adhered to the policies, procedures and methodologies;
 - examination of the process to obtain the necessary approvals;
 - re-performance of the calculation or carrying out appropriate estimations on the provision amount; and
 - checking that the provision amount has been properly recorded in the books and accounting records of the AI.

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

77. The auditor would also consider carefully the implications of any examinations performed by the HKMA, internal audit of an AI or other parties on an AI's internal control systems or asset quality. A material finding arising from such an examination can be an indicator of potential issues with the control systems in place and which may form the basis of an exception to be reported under section 63(3A).

Correct compilation of returns and information from books and records

78. The auditor’s work in testing the compilation process can be viewed or conducted in conjunction with the work done on specific returns under section 63(3). AIs regularly submit information to the HKMA for statistical and prudential supervision purposes. However, the work performed under section 63(3) is, in practice, only limited to a few key returns in a particular period. Consequently, the HKMA is seeking to gain additional comfort on the reliability of the information submitted in other returns throughout the year by way of an examination of the broader return compilation process of an AI.
79. The HKMA has set out in its Supervisory Policy Manual that AIs should have adequate systems of control to enable the submission of reliable statistics and information to it. The auditor is required under section 63(3A)(a)(i) to report on the effectiveness of the systems of control set up to ensure the correct transfer of information from records to returns. The statistics and information would be complete, accurate and prepared in accordance with completion instructions issued by the HKMA. It should be noted that the systems of control would cover not only periodic returns submitted to the HKMA but also other information such as ad hoc surveys and statistics that the HKMA may request from an AI from time to time under section 63(2). The controls expected to be in place and the type of work that could be undertaken to enable the auditor to report on the effectiveness of controls would include the following:
- a. Controls over data capture for compilation of returns*
- AIs have controls in place to ensure that data that is necessary to enable reporting of information to the HKMA is captured completely and accurately. In most circumstances, reporting to the HKMA would be based on a set of predefined criteria and format. As such, it is important that adequate guidance on data definitions and the data capturing process are made available to responsible personnel so that they acquire a proper understanding of the requirements for data capture.
 - The auditor would perform procedures to assess whether the relevant officers have an appropriate level of understanding of the reporting requirements taking into account the adequacy of guidance available for the purpose of capturing such information.
- b. Understanding of the return compilation process and requirements*
- Persons responsible for compilation of returns from the AI’s books and records have an adequate understanding of the regulatory requirements and definitions set out by the HKMA in the relevant completion instructions and how they should be applied in the context of the AI’s business and operations. The existence of a procedures manual containing an appropriate level of detail provides a source of reference to officers involved to facilitate their understanding of the compilation process and the procedures that are to be carried out in compiling returns and information. Such a procedures manual would set out the timing of reports, compilation procedures, source of information, and other procedures carried out to collect information to ensure complete, accurate and timely compilation of returns and other information. In addition to a procedures manual, guidelines and instructions and relevant correspondence and discussions between the AI and the HKMA which relate to compilation of returns and information would be maintained, filed and made available to responsible officers for reference purposes.
 - The auditor would consider the adequacy of the processes and information in place to ensure that this understanding is updated for changes in regulatory reporting requirements as well as changes in business or operations. The auditor would also check the documentation of the control systems, and clarify the understanding of the systems with management to confirm the systems operate in the manner recorded.

The auditor is generally expected to perform tests on the effectiveness of these control systems.

c. Maintenance of adequate audit trail

- AIs maintain clear, concise and organized documentation supporting the compilation of returns and other information from the relevant books and records so that there is a clear and traceable link between the underlying records and the completed returns.
- The auditor would carry out procedures to examine such documentation and perform tests as to whether the information contained in the completed returns and other information are compiled from the underlying books and records and seek appropriate explanations on any material errors or discrepancies thereon from management.

d. Process for clarifying issues

- AIs have in place a process whereby questions and issues (e.g. treatment of particular transactions for reporting purposes) that may arise in the course of compiling returns are identified and resolved in an appropriate manner. Such a process would include escalating the issue to appropriate personnel within the AI and where necessary, referred to the HKMA for clarification. All such clarifications would be properly documented and maintained for future reference purposes.
- The auditor would assess any material issues raised and be satisfied that the manner in which such issues were resolved was appropriate and in accordance with the relevant reporting requirements.

e. Review and approval

- Both the Chief Executive and the Chief Accountant or their equivalents are required to sign off on the returns submitted to the HKMA. The sign-off process is supported by adequate review and approval procedures during the course of the compilation. The purpose of such a review and approval process is to enable errors or inconsistencies to be identified and allow corrections to be made prior to the submission of the information to the HKMA. The review and approval procedures are performed by an officer independent of the preparation process and with an appropriate level of understanding of the requirements and how they are applied to the business and operations of the AI.
- The auditor would appraise the review and approval procedures as well as the experience of those responsible for such reviews and assess the adequacy and effectiveness of these procedures by way of observation, re-performance, or inquiry with relevant personnel.

f. Use of computer-based tools and systems

- AIs commonly make extensive use of computer-based tools and systems in their operations and for maintaining their accounting records. Such AIs place significant reliance on the ability of these systems to ensure that information is captured, processed and reported accurately and completely. The use of computer-based systems to facilitate the compilation of returns and other information from books and records of an AI is also increasingly common.
- Where AIs operate computer-based systems to process information used for compiling returns and other information or rely on such systems to automate the compilation process, the auditor would consider assessing the adequacy of controls over such systems.

g. Backup arrangements

- Staff changes can arise due to various reasons including planned and unplanned leave, rotation of duties, resignations, etc. AIs would have in place procedures to ensure that staff changes do not have any adverse impact on the quality of returns and other information or on the timing of their submission to the HKMA.
- The auditor would understand the AI's backup arrangements and assess whether backup staff responsible for compiling returns and other information have an adequate understanding of the requirements and procedures to be carried out.

Compliance with specific provisions of the Ordinance

80. The guidelines issued by the HKMA require AIs to have effective monitoring and reporting systems to enable compliance with their statutory duties under the Ordinance at all times. While this is a general principle which applies to all duties under the Ordinance, the auditor will be asked particularly to report on those controls relevant to the duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII (section 63(3A)(a)(ii)) of the Ordinance. To meet this reporting requirement, the auditor would identify whether appropriate control procedures are in place to enable the AI to comply with its statutory duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance and test whether such control procedures are operating effectively.
81. The types of controls that AIs normally have in place to enable compliance with their statutory duties under the Ordinance at all times include:
- Procedures to ensure that management is fully aware of the relevant statutory provisions and regulatory requirements as they apply to the AI's operations;
 - A repository of information containing the Ordinance, guidelines and circulars issued by the HKMA, communications with the HKMA and any amendments to all such documents is maintained, and procedures to ensure effective communication of such information to relevant personnel in the AI;
 - Formal policies on compliance with the provisions of the Ordinance;
 - Procedures on ensuring compliance with statutory and regulatory requirements in all aspects of the AI's operations are maintained. Such procedures may include setting of appropriate limits and targets, monitoring and reporting transactions against limits and targets, stress testing, etc. These procedures would deal not only with day-to-day operations but also the process of introducing new products and businesses;
 - An officer (such as a compliance officer) designated with the responsibility for monitoring and ensuring compliance with statutory and regulatory requirements;
 - Reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant members of management (including the compliance officer) and actions on non-compliance are taken in a timely manner;
 - Procedures for reporting any compliance failure to the HKMA in a timely manner are established;
 - The monitoring of compliance is supported and evidenced by clear, concise and organized documentation to provide an audit trail for subsequent verification.
82. Part XII of the Ordinance deals with the requirements to disclose information to the HKMA, and the auditor's reporting responsibilities in this regard are addressed in the work on examining the AI's control systems for the correct compilation of returns or information from the books and records.

83. A report for the purpose of section 63(3A) also requires the auditor to conclude on whether adequate controls are in place to enable compliance with the following provisions of the Ordinance:

- Part XV – Limitations on loans by and interests of AIs
- Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)
- Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio

84. The types of controls which are normally in place in the AI to enable compliance with the above provisions and which the auditor would take into account in designing the procedures include:

a. Part XV – Limitations on loans by and interests of AIs

- Written policy in respect of taking of own shares as security, large exposures and advances to connected parties, shareholdings in other companies and interests in land;
- Establishment of appropriate internal limits (within the statutory limits under the Ordinance) for individual customers and groups of related customers, shareholdings and interests in land and sub-limits for various business units, branches or subsidiaries;
- Process for identifying and reporting breaches against internal limits to senior management on a continuing basis;
- Timely reporting of positions and exposures to management to enable appropriate actions to be taken;
- A system to capture all up-to-date financial exposures to a particular customer or group of related customers, irrespective of whether they are exempted or not;
- Procedures to ensure that compliance checks are performed prior to approval of facilities;
- Procedures to enable the terms and conditions for exemptions granted by the HKMA on exempted exposures to be monitored and complied with on an ongoing basis.

b. Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)

- Written policy on the AI's strategy on maintaining capital adequacy for the purpose of both its business activities and to meet regulatory requirements;
- Establishment of target capital ratios which are above the minimum required for business or regulatory purposes;
- Process for identifying and reporting breaches against target ratios to senior management on a continuing basis;
- Budgets prepared to take into account capital adequacy requirements and changes in capital adequacy as a result of projected asset mix, balance sheet growth and capital resources;
- Capital adequacy ratios are calculated and reported to management on an ongoing basis;

- Procedures on assessing impact of large loans, investments or other significant transactions on capital adequacy prior to the transaction taking place;
- Stress-tests are performed on capital adequacy ratio on a regular basis.

c. Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio

- Written policy on the AI's strategy and procedures for maintaining adequate liquidity at all times to meet business and regulatory requirements;
- Target ratios for liquidity and maturity mismatch (if any) which are above the minimum regulatory requirements are set and procedures are in place to identify and immediately report breaches or exceptions to senior management;
- Procedures are in place to allow liquidity and maturity mismatch ratios to be reported and monitored on an ongoing basis;
- Procedures on assessing impact of large loans, investments or other significant transactions on liquidity prior to the transaction taking place;
- Contingency plans are in place for coping with various types of liquidity crisis;
- Stress-tests are performed on the liquidity position on a regular basis.

85. A checklist of questions concerning compliance with Part XII, XV, XVII or XVIII of the Ordinance is set out in Appendix 7 to this PN.

86. Other procedures that the auditor may consider in assessing controls to ensure compliance with Parts XV, XVII and XVIII are set out in the HKMA's Supervisory Policy Manual IC-3, Annex B.

Maintenance of adequate provision

87. For locally incorporated AIs only, the auditor is required to report on whether or not, during the period, the AI had in place systems of control which were adequate to enable it, as much as is practicable, to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur, and if those systems were not adequate the nature and extent of those inadequacies.

88. Maintenance of adequate provision is one of the key criteria for maintaining an authorization and for many AIs, an area of particular focus by management. The HKMA has also issued guidelines on loan classification and provisioning requiring AIs to have adequate policies and procedures for the regular appraisal of the quality of their assets and for the establishment of adequate provision for bad and doubtful debts.

89. The auditor, as part of the statutory audit may have performed certain procedures relating to the maintenance of adequate provision and the work required to comply with the statutory reporting duties under this section may be an extension of the work performed for statutory audit purposes.

90. The types of controls AIs would normally maintain to ensure that they meet the objective of maintaining adequate provision include:

- Written policies and procedures setting out the frequency of review, methodology and level of provision to be maintained for each class of exposure (e.g. on- and off-balance sheet);

- An appropriate loan classification system with clear definitions (both qualitative and quantitative measures) for each class of exposures to allow monitoring of asset quality on a regular basis;
- Minimum provision levels are set and observed for each class in the classification system;
- Responsibilities for reviewing and approving provision are clearly allocated to officers or committees with sufficient authority;
- The credit process includes procedures for:
 - monitoring of asset quality and concentration risks by country and sector;
 - monitoring of adverse economic or political factors which may have an effect on asset quality or borrowers' repayment ability;
 - monitoring of overdue, rescheduled or over-limit assets;
 - reviewing irregularities in individual credit exposures;
 - reviewing the borrowers' and guarantors' financial position;
 - reviewing and updating the value of collateral on a regular basis.
- Procedures are carried out to review and assess the level of provision on a regular basis;
- Provisioning decisions are recorded, documented and reported to senior management, an appropriate committee and to the Board on a regular basis;
- Procedures are carried out to review the value of assets on a regular basis (such as fixed assets, investments and other assets) to assess whether impairment or loss exists;
- Procedures are in place to identify and determine an appropriate level of provision for liabilities including assessments of whether contingent liabilities should be recognized as liabilities on the balance sheet (e.g. litigation cases).

Representations by management

91. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management's responsibility for establishing and maintaining the systems of internal control and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that management has disclosed to the auditor all material weaknesses in the internal control systems of which it is aware and also those areas for which management believes the cost of corrective action may exceed the benefits;
 - c. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondence with the HKMA, etc.) for the purpose of the auditor's examination of the internal control systems, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
 - d. describing any irregularities involving management or employees who have significant roles in the systems of internal control;
 - e. stating whether there were any changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses;

- f. stating whether there have been communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the returns;
 - g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period;
 - h. for locally incorporated AIs only, confirming that the AI has maintained adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses during the relevant period;
 - i. for registered institutions, confirming that the AI has complied with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (see paragraphs 129 to 137);
 - j. confirming that management is not aware of any matters which would adversely affect the financial position of the AI to a material extent; and
 - k. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report.
92. An example management representation letter is set out in Appendix 2 to this PN – Example 2.

Materiality

93. An exception which would be reported for the purpose of a report under section 63(3A) would relate to either:
- a material weakness in controls over (i) compilation of returns and other information, (ii) compliance with certain provisions of the Ordinance, and (iii) maintenance of adequate provision;
 - an actual contravention of the Ordinance; or
 - inadequate provision.
94. The auditor would exercise judgment on whether a weakness or failure in the control systems is material taking into account the impact such a weakness or failure may have on the quality of the reported information, the ability of the AI to comply with relevant provisions of the Ordinance and to maintain adequate provision. In respect of an overseas incorporated AI, it is a weakness or failure in the control systems which is material in the context of the AI's operations in Hong Kong which would be reported.
95. Considerations on materiality in the context of reporting under section 63(3A) are wide ranging and vary depending on the nature, size and complexity of the AI concerned. Whilst an actual contravention of the Ordinance is generally a factual matter, what is considered to be material for the purpose of reporting on controls and adequacy of provision requires the exercise of judgment in the context of the AI concerned. The auditor would perform adequate procedures to confirm existence and effectiveness of controls on areas which, in the auditor's judgment, are material with respect to the AI.
96. The auditor would normally be required to report separately under section 63(3) on whether specific returns were compiled based on the AI's books and records. Errors or exceptions (whether material or not) identified in the course of the auditor's work for the purpose of section 63(3) are prima facie evidence that there may be an internal control weakness in the

compilation process. Therefore, the auditor would consider carefully the underlying reasons leading to such errors and assess the implications on the work under section 63(3A).

97. When evaluating the manner in which a specific finding should be reported, the auditor would take into account the requirements of Supervisory Policy Manual and guidelines issued by the HKMA and any potential impact on the AI's financial position.

Reporting

98. The auditor's report under section 63(3A) is a report on both the existence of appropriate controls and whether such controls have operated effectively during the specified period. The opinion in the auditor's report under section 63(3A) is structured into two main parts. The first part is an opinion for the purpose of section 63(3A)(a) on whether controls are in place to enable:

- the AI to correctly compile from its books and records, in all material respects, the returns and other information, which are required to be submitted to the HKMA;
- the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance; and
- the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur (for locally incorporated AIs only).

The second part is an opinion for the purpose of section 63(3A)(b) given on the basis of the work performed under section 63(3A)(a), on whether the auditor was aware of:

- any instances where the AI has materially contravened any of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance; and
- for locally incorporated AIs, any instances where the AI has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

99. The opinion in respect of section 63(3A)(b) is drawn from the work performed under section 63(3A)(a). However, the HKMA would expect the auditor to take into account any other information which comes to the attention in the capacity as the auditor of the AI, including any information obtained from the normal course of any audit work performed and in the auditor's examination of specific returns under section 63(3).

100. An appropriate description of any weakness or failure in the control systems considered to be material would be reported together with the auditor's recommendations for improvement where possible.

101. The auditor should carry out a reasonable assurance engagement in accordance with HKSAE 3000 and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 and with reference to PN 830. The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within three months from the end of the specified period and the AI would forward the auditor's report together with any comments thereon within a further one month.

102. Examples of auditor's reports under section 63(3A) are set out in Appendix 1 to this PN – Examples 3 and 4.

Ad hoc reports under section 59(2)

General

103. The HKMA has discretionary power under section 59(2) to require an AI, after consultation with the AI, to provide an auditor's report on any matters the HKMA may specify which are relevant for the exercise of its functions. This power enables the HKMA to require an AI to appoint the auditor to report on internal controls, specific transactions, or any other matters which are relevant for the performance of its functions under the Ordinance.
104. A report under section 59(2) is commissioned on an ad hoc basis. The circumstances which can lead to a decision by the HKMA to commission such a report generally relate to the identification of issues or events which pose a significant adverse risk to the AI's financial position, business or operations, or represent a threat to the interest of depositors or stability of the banking sector. Such issues or events can arise from:
- significant internal control weaknesses raised in management letters from the AI's auditor;
 - issues arising from reviews by the HKMA or internal auditors;
 - frequent errors in returns submitted to the HKMA;
 - occurrence of an adverse event (e.g. fraud) affecting the AI;
 - significant exposures to certain high risk business activities.
105. As set out in the HKMA's Supervisory Policy Manual IC-3, the HKMA can also require a report to be commissioned on the financial affairs of the AI, based on an audit of its financial statements, if the HKMA has reason to believe that the normal audit carried out by the auditor was, or is likely to be, deficient.
106. The AI's statutory auditor may be appointed for the purposes of reporting under section 59(2). Even where there are no doubts about the capability of the statutory auditor, the HKMA has the right to require that a report under section 59(2) be obtained from another audit firm to obtain a fresh perspective on matters which are the subject of the report.
107. The extent of the detail included in the auditor's report concerning the description of the relevant internal controls and of the procedures undertaken to test the operation of those controls to support the conclusion provided is a matter of judgment for the auditor. The auditor would have regard to the expectations of the HKMA and the AI and would evaluate the risk of misinterpretation or misunderstanding in this regard.
108. The auditor would seek to ensure that the extent of the description of the relevant internal controls to be included in the report and the extent of the procedures to be undertaken is specified in the Letter of Instruction issued by the AI. Similar principles apply to any other engagement requiring the exercise of significant judgment.

Scope

109. Due to the fact that a section 59(2) report is commissioned on an ad hoc basis, the HKMA would consult with the AI and the auditor on the scope of work and agree in advance on the terms of reference prior to issuing a notification in writing to the AI requiring such a report.
110. During the discussion with the HKMA and the AI regarding the scope to be covered in the ad hoc review, the following factors would be taken into account:
- Exact scope (including any specific concern) that the HKMA would like to be covered in the ad hoc review;
 - Agreed assurance and materiality level;

- Specific areas of concern that the HKMA would like the auditor to cover in the ad hoc review;
 - Specific guidelines on format of deliverables, including level of assurance required from the auditor.
111. The period to be covered by a report under section 59(2) will vary depending on the circumstances, but the HKMA has indicated that it will not normally exceed 12 months. Factors to be taken into consideration in determining the period to be covered include whether:
- there is enough evidence of policies, controls and records available in the period (for example, whether relevant senior management meetings will have taken place); or
 - changes are expected in the area(s) to be examined (for example in systems, processes, management or products). If so, the auditor would determine whether the auditor's report is intended to reflect the position before, after or during the change period.
112. In certain circumstances, the auditor might be unable to assess the proposed scope sufficiently without a greater understanding of the AI's operations in the area to be examined – for example the organizational structure, product profiles or volumes of transactions. This can arise where the auditor is not the AI's statutory auditor or the scope relates to an area that is not covered extensively by statutory audit work. In these circumstances, the auditor may wish to agree with the HKMA and the AI that a short initial visit to the AI be undertaken before the final scope of the work is agreed. This would enable the auditor to assist the HKMA in refining the scope more effectively.
113. Where applicable, the auditor would agree with the HKMA and the AI on which of the AI's legal entities, divisions, or businesses the report would cover.
114. The auditor's report would normally be submitted to the AI within a period of three months from the date of the notification letter issued by the HKMA and forwarded to the HKMA together with comments from the AI within a further month. The reporting deadline can be varied at the discretion of the HKMA to take into account special circumstances after consultation with the AI and the auditor concerned.

Nature of work

115. The work that the auditor performs for the purpose of reporting under section 59(2) would vary depending on the circumstances surrounding the commissioning of such a report and the subject matter. As such, the engagement can be a reasonable or limited assurance engagement or an engagement to perform agreed-upon procedures or others.
116. For reasonable or limited assurance engagement, the auditor should consider to conduct the work in accordance with HKSAE 3000. The auditor would seek to develop and establish suitable criteria for the engagement based on specified modules of Supervisory Policy Manual or guidelines issued by the HKMA. The modules of Supervisory Policy Manual or guidelines issued by the HKMA used would be agreed in advance. The determination of whether the engagement provides reasonable assurance or limited assurance would depend on the level of assurance required in the circumstances of the engagement. For agreed-upon procedures engagement, the auditor should perform the engagement under HKSRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information".
117. Paragraph 116 only provides reference for the auditor and it is not served to limit the appointed auditor's professional judgment and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Materiality

118. Given the varying nature of ad hoc reviews under section 59(2), the auditor would ensure that clear reference points have been agreed with both the AI and the HKMA to determine the level of assurance that can be provided under given terms of reference. For some engagements, the terms of reference can be expressed in terms of one or more HKMA's and / or other requirements. Some terms of reference are highly specific, quantitative and objective and therefore readily capable of reliable and consistent measurement and interpretation. Some terms of reference are general, qualitative and highly subjective. Others may fall between these two extremes.
119. In order to assess fully the level of assurance that is appropriate concerning general, qualitative, subjective terms of reference, the auditor, where necessary, would assist the HKMA and the AI to prepare, a set of specifically developed criteria which are more capable of reliable and consistent measurement and interpretation in light of the requirements of the HKMA. In many cases, reference can be made to Supervisory Policy Manual and guidelines issued by the HKMA and other pronouncements which set out in sufficient detail the assessment criteria to support an assurance engagement. However, the HKMA remains responsible for determining whether the specifically developed criteria meet its purposes for commissioning a report.

Reporting

120. The auditor would consider whether it is necessary to provide in the report an introductory or background section to set in context the conclusion (or overall findings otherwise reported).
121. Such background information is relevant to the area examined in the report and can include, for example, a description of the organization in that area, the main business lines, the profile of the business and the market significance in the sector and the description of the procedures undertaken.
122. Detailed narrative reports are normally necessary in order to communicate properly the judgments made, the reasons underpinning those judgments and the context in which a conclusion is provided. The implications for the auditor are that a report covering internal controls includes, inter alia, comparatively detailed descriptions of:
- the elements of the design and operation (as applicable) of the internal control systems that are subject to evaluation; and
 - the extent and nature of the procedures undertaken to gain assurance that the internal controls specified operate as prescribed (if part of the scope).
123. The description of the procedures undertaken includes, where appropriate, such matters as details of documents examined, persons interviewed and tests of detail performed.
124. The auditor would attach a copy of the engagement letter and the Letter of Instruction from the AI as appendices to the auditor's report.
125. An example of a report under section 59(2) is set out in Appendix 1 to this PN – Example 5.

Notification of audit qualifications or adverse statements under section 59A(2)(c)

126. Under section 59A(2)(c), the auditor of an AI appointed under section 395, 396, 397 or 398 of the Companies Ordinance is required to provide written notice to the HKMA if the auditor decides to include in the audit report on the AI's financial statements any qualification or adverse statement as to a matter mentioned in section 406 or 407 of the Companies Ordinance.

127. The issue of a qualified audit report or an adverse statement in relation to a matter under section 406 or 407 of the Companies Ordinance may have a potentially significant impact on the AI concerned and have to be communicated to the HKMA as soon as reasonably practicable. Except for matters required to be reported under sections 63A and 63B, the auditor would normally be expected to discuss with the AI any matter about which the auditor is concerned, and request that the AI draws the matter to the attention of the HKMA. Nevertheless, it is important for the auditor to strike a balance between preserving the professional relationship with the AI, the possible impact on depositors' interests arising from a delay in reporting and the need to take appropriate legal advice in deciding whether to report such an issue via the AI or directly to the HKMA. In relation to a qualification or an adverse statement, the auditor would take into account the severity of the matter as well as the AI's response to the auditor's request to communicate the matter to the HKMA.
128. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has set out examples of the circumstances where it believes management of the AI should not be informed in advance in the interest of protecting depositors and the auditor should report directly to the HKMA after considering appropriate independent legal advice. The auditor would make reference to these examples in assessing the circumstances surrounding the qualification of the audit report on an AI's financial statements or an adverse statement in connection with a matter under section 406 or 407 of the Companies Ordinance.

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

129. Sections 63A and 63B require AI's auditor to submit a report to the HKMA if the auditor becomes aware of any matter in the course of performing the duties as the auditor that in the auditor's opinion:
- Adversely affects an AI's financial position to a material extent (section 63A); or
 - Constitutes on the part of an AI that is a registered institution under the Securities and Futures Ordinance ("SFO") a failure to comply with certain provisions or rules made under the SFO (section 63B).
130. Matters which are required to be reported under sections 63A and 63B have to be reported by the auditor in writing directly to the HKMA as soon as is reasonably practicable. There is no specified format for such a report but the report would cover the nature of the matter and the reasons why the auditor is of the opinion that the matter should be reported.
131. Section 63A requires the auditor which is appointed under section 59(2), 63(3) or 63(3A) of the Ordinance or section 395, 396, 397 or 398 of the Companies Ordinance to report to the HKMA if the auditor becomes aware of a matter which, in the auditor's opinion, adversely affects the financial position of an AI to a material extent. The auditor would consider any such matter which comes to the auditor's attention in the context of the AI as a whole. In relation to an overseas incorporated AI, the requirement of section 63A applies to its principal place of business in Hong Kong and its local branches and as if the principal place of business in Hong Kong and those branches were collectively a separate AI.
132. Some of the matters which the HKMA would expect to be reported under section 63A include the following:
- whether the AI's status as a going concern is questionable (e.g. a material loss that may threaten the financial condition of the AI);
 - whether the AI's capital adequacy ratio has dropped, or will drop, significantly to a level which may be detrimental to depositors;
 - whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.

133. As matters which are reportable under section 63A relate to the financial position of AIs, the auditor is expected to take into consideration potential issues that may constitute a reportable matter under this section in the course of performing the work on AI's financial statements or for the purpose of reporting under section 59(2), 63(3) or 63(3A).
134. Under section 63B, when the auditor becomes aware of a matter that, in the auditor's opinion, is a matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the SFO (a "reportable matter"), the auditor shall, as soon as practicable after the auditor becomes aware of the matter, submit to the HKMA a report in writing on the matter.
135. A reportable matter in respect of AIs refers to a matter that, in the auditor's opinion constitutes on the part of the AI a failure to comply with any prescribed requirement. Prescribed requirement refers to the requirements of any rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO. However, it should be noted that section 63B specifically excludes the requirements under section 149 of SFO in relation to holding of client monies.
136. The HKMA has recognized that there is no obligation for the auditor to specifically perform work or to change the scope, nature and depth of the work to identify non-compliance with the requirements of the SFO where such work does not already form part of the procedures carried out for the purpose of an audit on the AI's financial statements, or for the purpose of reporting under section 59(2), 63(3) or 63(3A). Therefore the auditor is not required to actively seek out grounds for making a report under section 63B and it is only when the auditor becomes aware, in the ordinary course of the work, of a reportable matter that the auditor would make a report to the HKMA.
137. A summary of the relevant regulations and requirements issued by the SFC that the auditor would have to be familiar with for the purpose understanding and fulfilling the duties under section 63B is set out in Appendix 6 to this PN.

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

138. Section 59A(2) requires the auditor of AIs appointed under section 395, 396, 397 or 398 of the Companies Ordinance to provide written notice to the HKMA if the auditor resigns before the expiration of the term of office (section 59A(2)(a)) or if the auditor does not seek to be re-appointed (section 59A(2)(b)). Such a written notice is required to be provided to the HKMA immediately.

Report of factual findings in relation to voluntary revocation of authorization

139. In an application for voluntary revocation of the authorization of an AI, the HKMA would require the AI to furnish a report by its auditor in respect of the balance sheet, third party deposit liabilities, contingent liabilities and outstanding commitments. This report would help satisfy the HKMA that the interests of the AI's depositors are or will be adequately safeguarded when the AI's authorization is revoked. The HKMA may provide a copy of the report to the Financial Secretary of the Hong Kong Special Administrative Region Government for the purpose of section 22(1).
140. A report by the auditor of factual findings in relation to a voluntary revocation of the authorization of an AI is an agreed-upon procedures engagement. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work. Reference would be made to HKSRS 4400 for details on the standards and guidance in this regard. An example engagement letter for a report of factual findings in relation to voluntary revocation of authorization is set out in Appendix 3 to this PN – Example 3.

141. The report of factual findings by the auditor is prepared based on specified procedures which would include the following matters:
- a. Whether the AI had any outstanding third party deposit liabilities according to the general ledger and customers deposit records of the AI as at a specified date, and whether this is consistent with the information in the management representation letter;
 - b. Whether the balance sheet as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the management representation letter; and
 - c. Whether the summary of contingent liabilities and outstanding commitments as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the board minutes and the management representation letter.
142. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management confirming, inter alia, the following areas as at the specified date for the purpose of the report:
- a. the accuracy and completeness of third party deposit liabilities of the AI;
 - b. the balance sheet was in agreement with the AI's books and records; and
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments.
143. An example management representation letter is set out in Appendix 2 to this PN – Example 3.
144. The report of factual findings is prepared in accordance with HKSRS 4400. A copy of the balance sheet of the AI and a summary of contingent liabilities and outstanding commitments (or a nil report if there are no contingent liabilities and outstanding commitments) as at the specified date would be attached to the report. An example of the report is set out in Appendix 1 to this PN – Example 6.

PART III – PROTECTION FOR THE AUDITOR ON COMMUNICATIONS WITH THE HKMA

145. Section 61 permits the auditor, notwithstanding any duty which the auditor may owe to the clients (e.g. confidentiality), to communicate to the HKMA, provided that:
- the communication, whether or not in response to a request by the HKMA, is in good faith; and
 - the information so disclosed relates to information or opinion on a matter of which the auditor becomes aware in the capacity of the auditor and which is relevant to any function of the HKMA under the Ordinance.
146. The protection covers not only the auditor appointed under section 395, 396, 397 or 398 of the Companies Ordinance but also the auditor appointed for the purpose of sections 50(1)(c), 59(2), 63(3) and 63(3A). It also covers the auditor who makes a report to the HKMA under sections 63A and 63B.
147. The protection afforded by section 61 is general and not restricted by the circumstances in which the information is obtained or by its sources. Provided the information becomes known to the auditor in the capacity as the auditor of an AI, they may communicate that information to the HKMA notwithstanding that:
- the information does not relate to the auditing work undertaken by the auditor; or
 - the source of the information was not the AI.
148. Section 61 does not of itself require the auditor to change the scope, nature and depth of the audit work and the auditor is not required to actively seek out grounds for making a report under this section.
149. Appendix 4 to this PN contains further guidance on ad hoc reports under section 61 that has been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61. Section 61 does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

APPENDIX 1 Examples of reports by the auditor

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

SECTION 63(3) REPORT BY THE AUDITOR TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Return of Capital Adequacy Ratio of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* as at [*date*];
- ii. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*];
- iii. Part I of the Return of Liquidity Position of the [*Institution and all its subsidiaries*]* [*Institution and certain of its subsidiaries set out below*]* [*Institution and its subsidiaries other than those set out below*]* [*Institution on a consolidated basis*]* [*Institution’s offices in Hong Kong*]* for the month of [*month/year*]; and
- iv. Parts I - III of the Certificate of Compliance of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*].

[The subsidiaries referred to in i., ii., iii. and iv. above are as follows:]*

Respective responsibilities of the directors and auditor

As the directors of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.² These procedures do not represent an audit of the books and records of the Institution.

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 830, “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

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

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Use of this report

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

ABC & Co.

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

Hong Kong

[Date]

* Delete where not applicable

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

SECTION 63(3) REPORT BY THE AUDITOR TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank’s Hong Kong Branch(es) (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution for the quarter ended [*date*];
- ii. Part I of the Return of Liquidity Position of the Institution for the month of [*month/year*]; and
- iii. The Certificate of Compliance of the Institution for the quarter ended [*date*].

Respective responsibilities of the chief executive and auditor

As the chief executive of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.³ These procedures do not represent an audit of the books and records of the Institution.

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 830, “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

³ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Use of this report

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

ABC & Co.

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

Hong Kong
[Date]

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

SECTION 63(3A) REPORT BY THE AUDITOR TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period:

- i. there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- ii. it appears that the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Respective responsibilities of the directors and auditor

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.⁴

⁴ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems 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 830, “Reports by the Auditor Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, in all material respects, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period,
 - i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

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

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. The situation where the auditor has no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*
- ii. The situation where the auditor has some reservation(s) about the institution's systems of internal control but has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*
- iii. The situation where the auditor has severe reservations about the institution's systems of internal control, and has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

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

SECTION 63(3A) REPORT BY THE AUDITOR TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank’s Hong Kong Branch(es) (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period, there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV and XVIII of the Ordinance.

Respective responsibilities of the chief executive and auditor

As the chief executive of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

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

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.⁵

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems 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 830, “Reports by the Auditor Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

⁵ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, in all material respects, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

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

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. The situation where the auditor has no reservations about the institution’s systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*
- ii. The situation where the auditor has some reservation(s) about the institution’s systems of internal control but has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*

- iii. The situation where the auditor has severe reservations about the institution's systems of internal control, and has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

Example 5 – Section 59(2) report

It should be noted that the scope and content of a report under section 59(2) would vary depending on the purpose and requirements of the HKMA in commissioning such a report. The example below focuses on a review of internal control systems and is only intended to provide an illustration of how such a review report could be structured and presented but other forms of presentation may be appropriate subject to discussion and agreement with the AI and the Monetary Authority. The precise details of the report should be suitably modified to suit individual circumstances.

SECTION 59(2) REPORT BY THE AUDITOR TO [Appropriate Addressee] OF XYZ BANK

In accordance with our engagement letter dated [date] (“Engagement Letter”), a copy of which is attached as Appendix [] to this report, we have carried out an engagement under section 59(2) of the Banking Ordinance (the “Ordinance”) in relation to matters specified in the Letter of Instruction issued by XYZ Bank (the “Institution”) dated [date].

Scope

The scope of our engagement is set out in the Letter of Instruction which requires:

1. a review of the internal control systems of the Institution which were in existence during the period from [date] to [date] (the “review period”) against the requirements set out in the following modules of Supervisory Policy Manual (“SPM”), guidelines and circulars issued by the Monetary Authority:

[list of all relevant modules of SPM, guidelines and circulars issued by the Monetary Authority]
2. *[set out other specified areas of review as appropriate]**

Respective responsibilities of the directors and auditor

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems which comply with the requirements of the Ordinance, and SPM, guidelines and circulars issued by the Monetary Authority. In fulfilling that responsibility, estimates and judgment must be made to assess the expected benefits and related costs of management information and of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that banking risks are properly monitored and evaluated and that transactions are executed in accordance with established authorization procedures and are recorded properly, to enable you to conduct the business in a prudent manner.

It is our responsibility to perform an engagement in accordance with the Engagement Letter addressing the scope set out in the Letter of Instruction and report on:

- a. whether we are aware of any matters which may indicate that the Institution has not established and maintained controls in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and
- b. *[set out responsibilities for other specified areas of review as appropriate]**.

based on the results of the procedures performed by us.⁶

⁶ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

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 830, “Reports by the Auditor Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) for the purpose of reporting on whether relevant internal control systems of the Institution were established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority.

In respect of [*other specified areas of review*], [our engagement was conducted in accordance with [*Hong Kong Standard on Assurance Engagements 3000*]* [*Hong Kong Standard on Related Services 4400 “Engagements to Perform Agreed-Upon Procedures Regarding Financial Information”*]* and with reference to PN 830 issued by the HKICPA.]⁷

We have performed such procedures [*as we considered necessary for the purpose of reporting in accordance with the above requirements*]* [*as were agreed and set out in the Engagement Letter*]*.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing, [with the exception of the matters set out in the Findings and Recommendations Report]:

1. having regard to the nature and scale of the business of the Institution, during the review period, nothing has come to our attention that causes us to believe that the Institution’s internal control systems were not established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and
2. [*conclude on other specified areas of review as appropriate*].

Findings and recommendations

The findings and recommendations arising from our review of the internal control systems are set out in Appendix [] to this report.

Use of this report

This report is for the information of the Institution and its Board of Directors in dealing with the matters set out in the Letter of Instruction dated [*date*] and for submission to the Monetary Authority. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [*Date*]

* *Delete where not appropriate*

⁷ This is for reference only and is not served to limit the appointed auditor's professional judgement and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Example 6 – Report of factual findings in relation to voluntary revocation of authorization**REPORT OF FACTUAL FINDINGS IN RELATION TO XYZ'S APPLICATION FOR VOLUNTARY REVOCATION OF ITS AUTHORIZATION AS A [*DEPOSIT-TAKING COMPANY / RESTRICTED LICENCE BANK / BANK*]***

In accordance with your Letter of Instruction dated [*date*], a copy of which is attached, we have performed the procedures below with respect to XYZ (the "Institution"). Our engagement was conducted in accordance with Hong Kong Standard on Related Services 4400, "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures were performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution's application for voluntary revocation of authorization as a [*deposit-taking company / restricted licence bank / bank*]*. The procedures are summarized as follows:

1. We inspected the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [*date*].
2. We obtained from the management the balance sheet of the Institution as at [*date*] and agreed to the books and records of the Institution as at [*date*].
3. We obtained from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [*date*] and compared it to the books and records.
4. For the contingent liabilities and outstanding commitments, we also obtained and reviewed the minutes of the Board of Directors ("Board Minutes") for the period from [*date*] to [*date*].
5. We obtained a Representation Letter from the Board of Directors confirming the following:
 - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [*date*];
 - b. the balance sheet as at [*date*] agreed with the books and records of the Institution;
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [*date*].

We report our findings as follows:

- a. With respect to item 1, we found there were no third party customer deposit liabilities attached as at [*date*], and this was consistent with the information in the Representation Letter.
- b. With respect to item 2, we found the attached balance sheet as at [*date*] was in agreement with the books and records of the Institution as at [*date*], and was consistent with the information in the Representation Letter.
- c. With respect to item 3, we found the attached summary of contingent liabilities and outstanding commitments as at [*date*] was in agreement with the Institution's books and records, and was consistent with the information in the Representation Letter.
- d. With respect to item 4, we were not aware of any inconsistency of the information in the Board Minutes.

Because the above procedures do not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, we do not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments as at [*date*].

Had we performed additional procedures or had we performed an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report. It relates only to the items specified above and does not extend to any financial statements of the Institution, taken as a whole.

This report is intended for filing with the Monetary Authority. We have no objection that a copy of this report is given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

** Delete where not appropriate*

APPENDIX 2

Examples of management representation letters

The following specimen letters are for reference only and will need to be modified according to the requirements and circumstances of individual AIs.

Example 1 – Management representation letter for reporting under section 63(3)

[Client's letterhead]

*[Audit Firm]
[Address]*

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3) of the Banking Ordinance to report on the following returns ("the Returns"):

- i) the [*consolidated*]* Return of Capital Adequacy Ratio of the [*Bank / Company*] as at [*date*]; [*applicable to locally incorporated AIs only*]
- ii) Parts I, II, and III, columns 1 - 5 of the [*consolidated*]* Return of Large Exposures of the [*Bank / Company / Branch*]* for the quarter ended [*date*];
- iii) Part I of the [*consolidated*]* Return of Liquidity Position of the [*Bank / Company / Branch*]* for the month of [*month/year*]; and
- iv) the [*consolidated*]* Certificate of Compliance of the [*Bank / Company / Branch*]* for the quarter ended [*date*].

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

The Returns

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting records and systems of control to ensure that the Returns have been correctly compiled from the books and records of the [*Bank / Company / Branch*]*, and that the [*Bank / Company / Branch*]* complies with the provisions of the Banking Ordinance at all times.
2. There have been no contraventions by the [*Bank / Company / Branch*]* of any of its duties under Part XII, XV, [*XVII*]* [*applicable to locally incorporated AIs only*] or XVIII of the Banking Ordinance during the period from [*date*] to [*date*] or which were the subject of correspondence during this period.
3. We are not aware of any matter which adversely affects the financial position of the [*Bank / Company / Branch*]* to a material extent.
4. [*For registered institutions only*] We are not aware of any matter that constitutes on the part of the [*Bank / Company / Branch*]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
5. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.
6. All the Returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the Monetary Authority.

Information Provided

7. All the Returns provided to you for the purpose of this engagement are the ones first submitted to the Monetary Authority.
8. All transactions undertaken by the [Bank / Company / Branch]* have been properly reflected and recorded in the accounting records.
9. All of the following information has been made available to you for the purposes of performing your procedures on the Returns:
 - i) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments (including derivative transactions and credit arrangements) of the [Bank / Company / Branch]*;
 - ii) All procedures manuals for the preparation of the Returns and compliance with the Banking Ordinance;
 - iii) Policies and procedures manuals for the key operating areas of the [Bank / Company / Branch]*;
 - iv) All instructions, correspondence and minutes or notes of meetings with the Monetary Authority;
 - v) Identities of all connected parties for the purpose of Part I of the Return of Large Exposures;
 - vi) Other information which may be relevant to the preparation of the Returns; and
 - vii) Unrestricted access to persons within the [Bank / Company / Branch]* from whom you determine it necessary to obtain audit evidence.
10. We have disclosed to you all communications between the [Bank / Company / Branch]* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the information presented in the Returns.
11. We have communicated to you all deficiencies in internal control of which we are aware of that could have a material effect on the information presented in the returns.

Yours faithfully

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

Director*/Chief Executive*

Chief Accountant

* *Delete where not appropriate*

Example 2 – Management representation letter for reporting under section 63(3A)

[Client's letterhead]

[Audit Firm]

[Address]

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3A) of the Banking Ordinance for the examination of our internal control systems to enable:

- i) the returns or information of the *[Bank / Company / Branch]** submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the *[Bank / Company / Branch]**;
- ii) the *[Bank / Company / Branch]** to comply with its duties under Parts XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* and XVIII of the Banking Ordinance; and
- iii) the *[Bank / Company / Branch]** to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur *[applicable to locally incorporated AIs only]*

for the period/year ended *[date]*.

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

Internal Control Systems

1. We have fulfilled our responsibilities for establishing and maintaining adequate internal control systems.
2. There were no changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses.
3. We are not aware of any violations or possible violations of the Companies Ordinance, the Banking Ordinance or any other regulations the effect of which should be considered for disclosure or as a basis for a provision.
4. There have been no contraventions by the *[Bank / Company / Branch]** of any of its duties under Part XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* or XVIII of the Banking Ordinance during the period from *[date]* to *[date]*. In particular, we confirm that the *[Bank / Company / Branch]** complied with sections [80, 81, 83, 85, 87, 87A, 88, 90, 98, 102 and 106] * *[applicable to locally incorporated AIs only]* [80, 85 and 102] of the Banking Ordinance as stated in the Certificates of Compliance submitted to the Hong Kong Monetary Authority ("HKMA") for the review period.
5. The *[Bank / Company]** has maintained at all times during the review period adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur *[applicable to locally incorporated AIs only]*.

6. We are not aware of any matter which adversely affects the financial position of the [Bank / Company / Branch]* to a material extent.
7. [For registered institutions only] We are not aware of any matter that constitutes on the part of the [Bank / Company / Branch]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
8. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

Information Provided

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

Yours faithfully

[For and on behalf of]

Director*/Chief Executive*

Chief Accountant

* Delete where not applicable

**Example 3 – Management representation letter for report of factual findings
in relation to voluntary revocation of authorization**

[Client's letterhead]

[Audit Firm]

[Address]

[Date of report]

Dear Sirs

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

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

Financial Statements

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting records and systems of control to ensure that the financial statements of the *[Bank / Company / Branch]** for the period from *[date]* to *[date]* have been properly prepared from the books and records of the *[Bank / Company / Branch]**.
2. We confirm the following:
 - (a) As at *[date]*, the third party deposit liabilities of the *[Bank / Company / Branch]** are accurate and complete;
 - (b) As at *[date]*, the *[Bank / Company / Branch]** 's balance sheet agrees with the books and records made available to you. The *[Bank / Company / Branch]** has maintained adequate provision for its liabilities and commitments as at *[date]*; and
 - (c) As at *[date]*, there are no other outstanding commitments or contingent liabilities which have not been wound down or properly honoured or transferred by mutually satisfactory arrangements except for those stated in the summary of contingent liabilities and outstanding commitments as at *[date]* and disclosed in the attachment to your report. The summary of contingent liabilities and outstanding commitments are accurate and complete.

Information Provided

3. All transactions undertaken by the *[Bank / Company / Branch]** have been properly reflected and recorded in the accounting records.
4. All of the following information has been made available to you for the purposes of performing your procedures:
 - (a) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments of the *[Bank / Company / Branch]**;
 - (b) All relevant instructions, correspondence and minutes or notes of meetings with the Monetary Authority and our solicitors; and
 - (c) Other information which may be relevant to your agreed-upon procedures.

Yours faithfully

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

Director*/Chief Executive*

* *Delete where not applicable*

APPENDIX 3

Examples of engagement letters

The following example letters highlight only the aspects relating to the scope and responsibilities of the auditor for the purpose of reporting under the Banking Ordinance. These examples are for reference only and require the inclusion of other relevant terms of the engagement which will vary according to the requirements and circumstances of the individual auditor and client. The auditor may consider it appropriate to include a limitation of liability clause in the engagement letter in accordance with the auditor's risk management policies.

Example 1 – Engagement letter for reporting under section 63(3) and (3A) for locally incorporated AIs

The Board of Directors
XYZ Bank
[address]

[Date]

Dear Sirs

Objective of services

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

Responsibilities of the directors

- 2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.

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

It is the directors' responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

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

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

- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii) the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii) the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

- 2.4 The directors are responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

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

- i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the Monetary Authority, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
- ii) In addition, our duty as auditor is to report whether or not, during the period:
- a) we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - b) we are aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

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

Scope of work

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

("SPM IC-3") issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.

- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.
- iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 and with reference to Practice Note 830 issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.
- ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

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

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services).

[Set out other terms of the engagements as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ Bank

**Example 2 – Engagement letter for reporting under section 63(3) and (3A)
for local branch(es) of overseas incorporated AIs**

The Chief Executive
XYZ Bank – Hong Kong Branch
[Branch address]

[Date]

Dear Sirs

Objective of services

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

Responsibilities of management

- 2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.
- 2.2 Reporting under Section 63(3) of the Ordinance
- It is management's responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.
- 2.3 Reporting under section 63(3A) of the Ordinance
- It is management's responsibility to establish and maintain adequate internal control systems to enable:
- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
 - ii) the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance.
- 2.4 The Institution's management is responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

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

- i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the HKMA, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
- ii) In addition, our duty as auditor is to report whether or not, during the period, we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.

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

Scope of work

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

4.2 Reporting under Section 63(3) of the Ordinance

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830 “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”). The procedures that we will perform to enable us to form our opinion will also be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.
- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution’s books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.

- iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 and with reference to Practice Note 830 issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.
- ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

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

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution and XYZ Bank rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services, or information provided to the head office of XYZ Bank and/or its other branches).

[Set out other terms of the engagements as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Chief Executive of XYZ Bank – Hong Kong Branch

**Example 3 – Engagement letter for report of factual findings
in relation to voluntary revocation of authorization**

The Board of Directors
XYZ
[address]

[Date]

Dear Sirs

Objective of services

- 1.1 You have requested that we prepare a report in relation to an application for voluntary revocation of authorization as a [deposit-taking company/restricted licence bank/bank]* by XYZ (the “Institution”). The scope and period to be covered in this engagement are set out in your Letter of Instruction dated [date]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our reporting the factual findings.

Scope of work

- 2.1 Our engagement will be conducted in accordance with Hong Kong Standard on Related Services 4400, “Engagements to Perform Agreed-upon Procedures Regarding Financial Information” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and we will indicate so in our report.
- 2.2 We have agreed to perform the following procedures and report to you the factual findings resulting from our work:
- i) Inspect the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [date].
 - ii) Obtain from the management the balance sheet of the Institution as at [date] and agree to the books and records of the Institution as at [date].
 - iii) Obtain from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [date] and compare it to the books and records.
 - iv) For the contingent liabilities and outstanding commitments, obtain and review the minutes of the Board of Directors for the period from [date] to [date].
 - v) With respect to (i) – (iii) above, we will also obtain a Representation Letter from the Board of Directors confirming the following:
 - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [date];
 - b. the balance sheet as at [date] agreed with the books and records of the Institution;
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [date].
- 2.3 The procedures are performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution’s application for voluntary revocation of the authorization as a [deposit-taking company/restricted licence bank/bank]*. Our report is intended for filing with the Monetary Authority. We have no objection that a copy of our report will be given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, our report should not be distributed to any other party or used by anyone else or for

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

- 2.4 The procedures that we will perform will not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA and, consequently, we will not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments.

[Set out other terms of the engagement as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ

**Delete where not appropriate*

APPENDIX 4

Guidance on ad hoc reports under section 61

The following guidance been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61 of the Banking Ordinance. Section 61 of the Banking Ordinance does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

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

The auditor

1. Section 61 provides that no duty to which an auditor of an AI shall be subject will be contravened "by reason of his communicating in good faith to the Monetary Authority, whether or not in response to a request made by the Monetary Authority, any information or opinion on a matter to which he becomes aware in his capacity as auditor and which is relevant to any function of the Monetary Authority under this Ordinance". It is this section which makes it clear that the auditor is able to communicate with the HKMA by way of a formal report, at a meeting or by any other means on any matters relating to the AI's affairs arising out of the appointment and which are relevant to any function of the HKMA under the Ordinance. These matters include those which are relevant to the reports made by the auditor, to any discussions with the HKMA and to those exceptional circumstances which are referred to in paragraphs 13 and 14 of this Appendix. The HKMA believes that the auditor may communicate a matter to the HKMA with the protection of section 61 regardless of the source of that information, provided the auditor becomes aware of the matter in the capacity as the auditor of that client AI.
2. Confidentiality is generally either an implied or explicit term of the auditor's contracts with the clients, but in section 61 circumstances it does not prevail since they are entitled to communicate information or opinions relating to the business or affairs of the AI without contravening the duty of confidence owed to the AI.
3. References in the following paragraphs of this guidance to "reporting under section 61" refer to reporting with the protection of section 61.
4. It is important to stress that the HKMA expects that the management of the AI will continue to be its primary source of information and that the normal reporting procedures, including the reports on statutory returns, the prudential meetings and any tripartite meetings will normally provide the HKMA with most of the information it needs to carry out its responsibilities under the Ordinance.
5. The auditor cannot, however, be expected to be aware of all circumstances which, had the auditor known of them, would have led the auditor to exercise the right to report under section 61. That section does not require the auditor to change the scope of the audit work, nor the frequency or timing of the audit visits. The auditor does not have an obligation to seek out grounds for making a report under section 61; the section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover an occurrence of the kind described in paragraph 10 of this Appendix. It is only when the auditor becomes aware in the ordinary course of the audit work of such an occurrence that the auditor would make detailed enquiries with section 61 specifically in mind.
6. The HKMA recognizes that it would not be appropriate for the auditor to report to it, information which the auditor has obtained through the professional relationship with another client which is not the AI, even though the information obtained or the matters identified may relate to the AI.

7. The auditor would realize that there are circumstances in which section 61 will not provide protection, for example, where the auditor could be held to have acted maliciously or in bad faith. The Ordinance does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by the auditor's action in reporting to the HKMA. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of the report are such as to secure the protection of section 61 and that it only includes relevant material. However, the auditor would recognize that speed of reporting may well be important in order to protect the interests of depositors. There is no protection given by the Ordinance if the auditor fails to report to the HKMA.

The HKMA

8. Information which is confidential and has been obtained by the HKMA under, or for the purposes of, the Ordinance can only be disclosed in given circumstances. However, under section 120(5)(g), the HKMA is not precluded from disclosing information "to an auditor of an authorized institution or former authorized institution or to a former auditor for the purpose of enabling or assisting the Monetary Authority to discharge his functions under this Ordinance". It should be noted that disclosure by the HKMA of confidential information to the auditor is to the auditor only; the auditor is not free to pass that information to others, such as the client AI without the HKMA's consent.
9. The HKMA has confirmed that it will take the initiative, usually by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditor:
 - a. when it believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of the audit or other report or the way in which the auditor carries out the reporting responsibilities; and
 - b. when the disclosure is for the purpose of enabling or assisting the HKMA to discharge its functions under the Ordinance or will otherwise be in the interests of depositors.

The HKMA will indicate whether management of the AI has been informed of the matter and if so, who has been advised. If the auditor is not informed by the HKMA of any such matter, the auditor is entitled to assume that the HKMA has no such disclosure to make. Accordingly, there is no need for the auditor to request the HKMA to confirm this.

Taking the initiative

10. The HKICPA has developed a criterion for use by the auditor in deciding whether to take the initiative in making an ad hoc report in addition to the regular reporting responsibilities. The criterion is that the auditor would take the initiative when the auditor considers it expedient to do so in order to protect the interests of depositors because there has been a material loss or there exists a significant risk of material loss. This criterion can be more fully explained as follows:
 - a. there must be an adverse occurrence, or a change in the auditor's perception of an existing situation, which may include an adverse change in the circumstances of the AI; and
 - b. the position described in a. above has given rise to a material loss or indicates that a reasonable probability exists that a material loss may arise; and
 - c. the position is such that the interests of depositors might be better safeguarded if the HKMA were aware of it.
11. As stated in paragraph 5 of this Appendix, the auditor is not required to seek out grounds for making a report. It is only where the auditor becomes aware during the ordinary course of the work that the criterion might be satisfied that the auditor would take the matter further.

Reporting via the AI

12. It is important for the auditor to act in a manner that will preserve the professional relationship with the client. Normally, therefore, the auditor would ask the AI to draw matters about which the auditor is concerned to the attention of the HKMA. Examples of circumstances encountered in which the criterion set out in paragraph 10 of this Appendix may be met and the matter reported via the AI are:
- a. when there appears to the auditor to be a material contravention of one or more of the requirements of the Ordinance;
 - b. where it has come to the attention of the auditor that there is an extreme situation, such as evidence of imminent financial collapse, where it is obvious that the HKMA must be informed;
 - c. where the auditor has evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's net assets;
 - d. when the auditor forms the opinion that there has been a significant failure of, or that there is a significant weakness in, the accounting and other records or the internal control systems;
 - e. when the auditor forms the opinion that management has reported financial information to the HKMA which is misleading in a material particular (or become aware that management has failed or does not intend to report something and the failure to report is, or would be, materially misleading).

Reporting direct to the HKMA

13. In exceptional circumstances, where it is in the interests of protecting depositors that the management of the AI should not be informed in advance, the auditor would report direct to the HKMA after first considering the appropriateness of taking independent legal advice. Examples of these circumstances are:
- a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where the auditor believes that a fraud or other misappropriation has been committed by the directors or senior management of the AI, or they have evidence of the intention of directors or senior management to commit such fraud or misappropriation;
 - b. where there has been an occurrence which causes the auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g. where the auditor has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the AI's affairs, or they have evidence of an intention so to act.
14. Additionally, as outlined in paragraph 16.b. of this Appendix, a direct report would be made where the AI will not itself inform the HKMA of a matter, having been advised to do so by the auditor or where it has not done so within the period of time specified, or where there is not adequate evidence that the AI has properly reported the matter in question.

Reporting procedures

15. In forming a view as to whether it is expedient to report a matter to the HKMA, the auditor would follow the procedures in making enquiries and obtaining and assessing relevant evidence which are a normal part of forming a professional judgment in relation to an audit or investigation.

16. Where the auditor becomes aware of a matter which in the professional judgment the auditor considers ought to be reported to the HKMA, the auditor would consider adopting the following procedures, bearing in mind that speed may be of the essence:
- a. The auditor would consider the facts and unless inappropriate in the circumstances, discuss the matter with the management of the AI.
 - b. In normal circumstances, the auditor would establish whether the matter has already been reported by the AI through the usual channels, and if so, obtain from the AI a copy of the HKMA's written acknowledgement sufficient to establish that the matter has been properly reported.
If the matter has not already been reported by management, the auditor would write to the AI setting out the views and requesting the directors or management to inform the HKMA of the matter, within a specified period of time. The auditor would then obtain from the AI evidence of prompt acknowledgement from the HKMA sufficient to establish that the matter has been properly reported.
In the absence of such evidence, it may be appropriate for the auditor to report the matter direct to the HKMA, and to inform the management of the AI of the contents of the report.
If the directors or management have not informed the HKMA and continue to refuse to inform it within the specified period of time, the auditor would report direct to the HKMA.
 - c. If the situation is sensitive, for example in the circumstances outlined in paragraphs 13.a. and b. of this Appendix, it may be inappropriate to discuss the matter with the normal levels of management. The auditor would, therefore, consider reporting to the appropriate senior level within the AI with a view to the HKMA being informed of the situation by a senior representative of the AI. The auditor would then obtain evidence from the AI of prompt acknowledgement by the HKMA sufficient to establish that the matter has been properly reported. In the absence of such evidence, it will then be appropriate for the auditor to report direct to the HKMA.

In exceptional circumstances where the auditor feels that in the interests of speed and/or, because of the nature of the matter, it is not appropriate or practical to inform or discuss the matter with anyone connected with the AI, the auditor would make an appropriate written or other report direct to the HKMA after considering the appropriateness of taking independent legal advice.

17. The auditor would have to satisfy themselves that the decision will stand up to examination at a future date on the basis of the following considerations:
- what the auditor knew at the time;
 - what the auditor should have known in the course of the audit or investigatory work;
 - what the auditor should have concluded; and
 - what the auditor should have done.
18. Speed of reporting will often be important to the protection of the interests of depositors. A report would be made as soon as the auditor reasonably can after forming the view that it is expedient to do so in order to protect the interests of depositors. For the auditor this may well mean ensuring that an ad hoc report is made to the HKMA in advance of making the report after considering the appropriateness of taking independent legal advice.
19. The auditor would note that in the situations outlined in paragraphs 13 and 14 of this Appendix, making an ad hoc report alone may not discharge all the auditor's responsibilities. An example of this would be the auditor considering the implications of the ad hoc report for the auditor's opinion on the financial statements.

20. To ensure that the HKMA is informed promptly of matters which meet the criterion, a firm acting as the auditor or reporting accountant would ensure:
- a. that all staff responsible for banking and deposit-taking assignments are aware of the provisions of the appropriate legislation and the contents of this guidance, and are able to identify situations in which section 61 might operate; and
 - b. that satisfactory procedures exist to ensure that any information, which may be the subject of an ad hoc report, obtained by staff in the course of the work, is passed on to the partner responsible without unnecessary delay.

APPENDIX 5

The Banking Ordinance – Important provisions for the auditor

This list is based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

Section

Powers of control over AIs

- 52 The Monetary Authority (MA) has powers to require an AI to take any action the MA deems necessary, to appoint a person to advise on the proper conduct of business, to assume control of the AI, to report matters to the Chief Executive in Council.

Power to examine and investigate AIs

- 55 The MA can examine books and records of an AI and group companies.

Audited financial statements

- 59 An AI and its auditor are required to comply with the Companies Ordinance with respect to the audit of the AI's financial statements; the MA has the power to appoint another auditor.
- 60 Requirement for an AI incorporated in Hong Kong to exhibit its audited financial statements in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch not later than 4 months after the end of the financial year.

Reports on statutory returns used for prudential purposes

- 50(1)(c) The MA can require an auditor's report on returns or information on an overseas branch of an AI incorporated in Hong Kong.
- 63(3) The MA can require an auditor's report on returns or other information submitted to the MA under this section.

Reports on internal control systems

- 59(2) The MA can request ad hoc reports by the auditor on certain internal control systems.
- 63(3A) The MA can request recurring annual reports by the auditor on certain internal control systems and other matters.

Notification in respect of the auditor

- 59A(1) Requirement for an AI incorporated in Hong Kong to notify the MA with respect to proposed or actual changes of the auditor.
- 59A(2) Requirement for an auditor of an AI appointed under section 395, 396, 397 or 398 of the Companies Ordinance to notify the MA if he resigns, decides not to seek reappointment or decides to qualify the financial statements.
- 63A Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter which, in his opinion, adversely affects the financial position of an AI to a material extent.

- 63B Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter that, in his opinion, is a matter that constitutes on the part of the institution a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section).

Communication by the auditor with the MA

- 61 Ability of the auditor to communicate to the MA certain information or opinion notwithstanding duties to clients (whether an AI or a former AI).

Investigations

- 117 Power of the Financial Secretary to appoint competent persons to investigate an AI and a former AI.
- 118 Duty of the auditor to provide information etc. to competent persons.

APPENDIX 6

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

This summary is based on the Securities and Futures Ordinance and its subsidiary legislation which were effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the law for the precise requirements.

Section 157 of the Securities and Futures Ordinance (SFO)

Under section 157(3) of the SFO, “prescribed requirement” means such of the requirements under any of the rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO for the purposes of this definition.

Section 5 of the Securities and Futures (Accounts and Audit) Rules made under section 397(1) of the SFO

The following provisions are prescribed requirements for the purposes of the definition of “prescribed requirement” in section 157(3) of the SFO:

- (a) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
- (b) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
- (c) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules.

The Securities and Futures (Client Money) Rules are rules made under section 149 of the SFO. According to section 63B of the Banking Ordinance, the requirements under section 149 of the SFO or of rules made under that section are excluded.

Securities and Futures (Keeping of Records) Rules

This is a set of subsidiary legislation made under section 151 of the SFO which specifies the records that intermediaries and their associated entities are required to keep, the manner in which they are required to be kept and other matters relating to the keeping of the records.

Relevant sections

- Section 3 General record keeping requirements for intermediaries
- Section 4 Record keeping requirements for associated entities

Securities and Futures (Client Securities) Rules

This is a set of subsidiary legislation made under section 148 of the SFO which prescribes the manner in which intermediaries and their associated entities shall treat and deal with client securities and securities collateral received or held in Hong Kong.

Relevant sections

- Section 4 Requirements in respect of a client’s standing authority
- Section 5 Requirement for deposit or registration of client securities and securities collateral
- Section 10 Limitations on treatment of client securities and securities collateral
- Section 12 Reporting of non-compliance with certain provisions of the Rules

APPENDIX 7

Checklist for the auditor

This checklist has been prepared for the guidance of the auditor who is required to report on compliance with Parts XII, XV, XVII and XVIII of the Banking Ordinance based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

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

Answer the following questions for the period to be covered by the report only:

**Section
Ref.**

Part XII Disclosure of Information

1. **Returns and information required by the HKMA**
 - a. Returns and information

63(1) Did the AI submit the required monthly and quarterly returns and such other information to the HKMA within the required 14 days or such period as the HKMA may require?
 - b. Matters which adversely affect the financial position of the AI to a material extent

63A Are you aware of any matter that may adversely affect the financial position of the AI to a material extent? If so, a report in writing on the nature of the matter and the reason supporting this opinion are required to be submitted to the HKMA.
 - c. Failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance

63B Are you aware of any matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section)? If so, a report in writing on the matter is required to be submitted to the HKMA as soon as reasonably practicable.
 - d. Shareholding

64(1)&(2) Has the AI informed the HKMA of the name, address, nature of business and other information required about companies:

 - i. in which the AI beneficially holds 20% or more of the share capital;
 - ii. where any director or manager of that company is also a director, chief executive or manager of the AI;
 - iii. where the name of that company has common features with the name of the AI;
 - iv. which, by whatever means, acts in concert with the AI to promote the AI's business; or
 - v. the controller of which is also the controller of the AI.

- e. Changes to constitution
- 65 Are there changes to the constitution of the AI of which the HKMA has not yet been notified within the required 30 days?
- f. Cessation of business
- 66 Has the AI ceased to carry on banking/deposit-taking business and if so, has it notified the HKMA in writing?
- g. Inability to meet obligations
- 67(1) Is the AI likely to become unable to meet its obligations or is it about to suspend payment? If so, has it notified the HKMA?
- 2. Maintenance of adequate provision for depreciation and diminution in value of assets**
- 63(3A) Has the AI at all times during the period under examination had in place systems of control which are adequate to enable it to maintain adequate provision:
- a. for depreciation;
 - b. against the diminution, if any, in the value of its assets, including provision for bad and doubtful debts;
 - c. for liabilities which will or may fall to be discharged by it; and
 - d. for losses which will or may occur?

Part XV Limitation on Loans by and Interests of AIs

- 3. Advance against security of own shares**
- 80 Has the AI complied with the requirement not to grant any advances, loans or credit facilities (including letters of credit) or give any financial guarantee or incur any other liability:
- a. against the security of its own shares; and
 - b. against the security of the shares of
- 80(2)
- i. any holding company of the AI;
 - ii. any subsidiary of the AI; or
 - iii. any other subsidiary of any holding company of the AI,
- except with the approval in writing of the HKMA?
- 4. Limitation on advances**
- 81(1)
- a. Has the AI instituted an adequate and effective management control to ensure that its financial exposure to:
 - i. any one person;
 - ii. any two or more companies which have the same holding company;

- iii. any two or more companies which have the same controller;
- iv. any holding company and one or more of its subsidiaries;
- v. any one person and one or more companies of which that person is a controller,

does not exceed 25% of its capital base?

Notes:

- 81(2) [1] *Financial exposure for this purpose means the aggregate of:*
- [a] *all advances, loans and credit facilities (including letters of credit) by the AI;*
 - [b] *the value of the AI's holdings of shares and debentures and other debt securities issued by that company, person or combination thereof;*
 - [c] *financial exposures (declared in a notice to be financial exposure) of the AI to that company, person or combination thereof; and*
 - [d] *the principal amount, multiplied by a factor specified by the HKMA and published in the gazette - for items referred to in Table B of the Third Schedule to the Ordinance.*
- 81(6) [2] *Financial exposure does not include:*
- *exposure to other AIs;*
 - *exposure to an overseas incorporated bank which is not an AI where it is, in the opinion of the HKMA, adequately supervised by the relevant banking supervisory authority;*
 - *exposure to the extent to which it is secured by a cash deposit, a guarantee, an undertaking which is similar to a guarantee, or securities issued, or guaranteed, by the central government or the central bank of any Tier 1 country within the meaning of the Third Schedule to the Banking Ordinance and such collateral or guarantee is accepted by the HKMA. The general criteria that the HKMA will apply in assessing whether such collateral or guarantee is acceptable are set out in the HKMA's Supervisory Policy Manual CR-L-2 "Exemption of Financial Exposures: §81(6)(b)(i)";*
 - *exposure to the extent to which it is covered by a letter of comfort accepted by the HKMA. See CR-L-3 "Letters of Comfort: §81(6)(b)(ii)" for the criteria that the HKMA will apply in assessing whether such letters of comfort are acceptable;*
 - *exposure acquired by the purchase of bills of exchange or documents of title to goods where the holder of such bills or documents is entitled to payment outside Hong Kong for goods exported from Hong Kong;*
 - *advances, loans and credit facilities made against the bills or documents mentioned above;*
 - *exposure to the Hong Kong Special Administrative Region Government or any other government acceptable to the HKMA;*
 - *share capital or debt securities held as collateral for facilities granted or acquired by the AI during debt recovery. In the latter case, the AI is, however, required to dispose of such collateral at the earliest possible opportunity, and in any case within 18 months after the acquisition or within such further period as may be approved by the HKMA;*
 - *an indemnity issued by the AI to a person to protect that person from any damages which may be incurred as a result of the person registering a transfer of shares (e.g. lost share certificates), provided that certain specified conditions are met;*

- *exposure acquired under an underwriting or sub-underwriting contract. If the exposure is an on balance sheet item, the exemption will only last for a period not exceeding seven working days or such further period as may be approved by the HKMA (see the HKMA's Supervisory Policy Manual CR-L-4 "Underwriting of Securities: §§81 and 87" for the HKMA's policy on extending the exemption period for the underwriting or sub-underwriting of securities);*
 - *exposure to a multilateral development bank as defined in the Third Schedule to the Banking Ordinance;*
 - *exposure to the Housing Authority arising from guarantees given to AIs under the Home Ownership or Private Sector Participation Scheme;*
 - *exposure to The Hong Kong Mortgage Corporation Limited (HKMC) arising from its obligations under the Mortgage Insurance Programme;*
 - *exposure to the extent that it has been written off or specifically provided for in the books of the AI; and*
 - *exposure to the HKMC or any company that issues mortgage-backed securities in connection with the HKMC's Guaranteed Mortgage-Backed Pass-Through Securitisation Programme, if the exposure to the HKMC or the company arises from the obligations placed upon it for the purposes of the Programme.*
- b. Are you aware of any financial exposure of the AI during the period under review which was in contravention of this limitation?
- 81(6) c. In respect of transactions covered by a "letter of comfort", is the aggregate amount of the financial exposure within the limitation imposed by:
- the HKMA; or
 - the terms of the letter of comfort?

Notes:

- [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

5. Compliance with guidelines on business practices

- 82(1) Has the AI complied with the requirement not to engage in those business practices specified in the guidelines, if any, published by the HKMA, after consultation with the Financial Secretary by notice in the Gazette?

Notes:

- [1] *The HKMA has the discretion to prohibit those business practices, which it considers will or may cause the soundness of the financial position of AIs to be dependent upon the soundness of the financial position of a single party.*
- 82(2) [2] *Such guidelines may apply to all AIs or to a class of AIs as specified in the notice.*
- [3] *Such guidelines may specify what constitutes a single party and, without prejudice to the generality of that power, any class or description of persons or business may constitute such a single party.*

6. Limitation on advances to directors etc.

- 83 a. Has the AI instituted an adequate and effective management control to ensure that it does not grant, or permit to be outstanding, any unsecured* advances, loans, credit facilities, financial guarantees or incur any other unsecured* liability to:
- 79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.
- 83(4) i. any director of the AI;
- ii. any relative of such director;
- iii. any employees responsible, either individually or as a member of a committee, for approving loan applications;
- iv. any relative of any such employee;
- v. any controller of the AI;
- vi. any relative of an individual who is a controller of the AI;
- vii. any firm, partnership or non-listed company in which the AI or any of its controllers or its directors (or relative of its controllers or directors) is interested as director, partner, manager or agent; and
- viii. any individual, firm, partnership or non-listed company of which any of the AI’s controllers or directors (or relative of its controllers or directors) is a guarantor,
- 83(1) to an aggregate amount in excess of
- aa. 10% of the capital base of the AI; or
- 83(2) bb. 5% of the capital base of the AI in respect of one or more persons included in i. to vi. above; or
- cc. \$1,000,000 in respect of any one person included in i. to vi. above.
- b. Are you aware of any loans or advances etc. granted or outstanding during the period under examination which were in contravention of any of these limitations?

Notes:

- 83(5) [1] *The above shall apply to a facility granted jointly with another party as they apply to a facility granted severally.*
- 83(1) [2] *The above section does not apply to AIs incorporated outside Hong Kong.*
- 79A [3] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

7. Limitation on advances to employees

- 85 Has the AI complied with the requirement not to grant, or permit to be outstanding, unsecured* advances, loans, credit facilities to, and not to give unsecured* financial guarantees or incur any other unsecured* liability in respect of, any one of its employees to an aggregate in excess of one year’s salary for any such employee?

79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA, be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.

8. Moneys placed with foreign banks

86 Is there any notice from the HKMA prohibiting the AI from granting any advances, loans, deposits or credit facilities to or directing the AI to demand repayment from any foreign banks?

Note:

86(4) “Foreign bank” means:

[1] any bank incorporated outside Hong Kong which is not licensed under the Banking Ordinance;

[2] any undertaking of an AI which is situated outside Hong Kong.

9. Limitation on shareholding

87(1) Has the AI complied with the requirement not to acquire or hold any share capital of another company or companies of an aggregate value which exceeds 25% of the capital base of the AI except that:

- a. such share capital is held as security for facilities granted by the AI; or
- b. such share capital is acquired in the course of satisfaction of debts due to the AI. In any event, such acquisitions must be disposed of within 18 months unless the HKMA has agreed to an extension of time.

- 87(2) c. by virtue of specified underwriting contracts; or
- d. in respect of shareholdings, approved in writing by the HKMA, in another AI or in a company carrying out nominee, executor or trustee functions or other functions related to banking/deposit-taking business or other financial services;
- e. in respect of any holding, approved by the HKMA, of share capital which is deducted in determining the capital base of the AI?

87A Has the AI complied with the requirement not to acquire all or part of the share capital of a company to a value of 5% or more of the capital base of the AI at the time of the acquisition except with the approval of the HKMA?

Notes:

87(1) [1] This section does not apply to AIs incorporated outside Hong Kong.

79A [2] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

10. Limitation on holding of interest in land

88(1) Has the AI complied with the requirement not to purchase or hold any interest in land situated in or outside Hong Kong of an aggregate value which exceeds 25% of its capital bases excluding:

- 88(2)/(3) a. land necessary for occupation for its business purposes or for staff housing; and
- 88(5) b. the value of land mortgaged to the AI by way of security for debts due to the AI, or the value of any interest acquired pursuant to entry into possession of land so mortgaged, provided that such mortgaged land must be disposed of within 18 months unless the HKMA has agreed to an extension?

Notes:

- 88(1) [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

11. Limitation on aggregate holdings

- 90(1) Has the AI complied with the requirement not to permit its aggregate holdings of:
- a. amounts outstanding of all facilities granted to specified bodies (as defined in section 83(3)&(4));
- b. shareholdings in other companies (as defined in section 87); and
- c. interests in land (as defined in section 88(1)&(2)),
- to exceed 80% of the capital base of the AI?

Notes:

- [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

Part XVII Capital Adequacy Ratio

12. Capital adequacy ratio

- 98(1) Has the AI maintained at all times during the period under review a capital adequacy ratio of more than the percentage stipulated by the HKMA as calculated in accordance with the provisions of the Third Schedule?
- 101(1)

Notes:

- 100(1)&(2) [1] *If the AI contravenes section 98(1) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.*
- 3rd Sch. [2] *The capital adequacy ratio shall be calculated as the ratio, expressed as a percentage, of its capital base to its risk weighted exposure as specified in the Third Schedule.*
- 98(2) [3] *If the AI has a subsidiary, the HKMA may, by notice in writing, require the capital adequacy ratio to be calculated on a consolidated basis, or both consolidated and unconsolidated basis. The notice may specify those subsidiaries to be included.*
- 98(2A)
- 98(3) [4] *The minimum percentage requirement may be varied by the Financial Secretary by notice in the Gazette.*

101(1) [5] *The percentage requirement of 8% may also be increased by the HKMA to not more than 12% for a particular bank, or 16% for a particular restricted licensed bank or deposit-taking company.*

98(1) [6] *The requirement does not apply to AIs incorporated outside Hong Kong.*

Part XVIII Liquidity Ratio and Matters Affecting Liquidity Ratio

13. Liquidity ratio

102(1) Has the AI maintained in the period under review a liquidity ratio of not less than 25% as calculated in accordance with the provisions of the Fourth Schedule and Part XVIII?

Notes:

4th Sch. [1] *The liquidity ratio shall be calculated as the ratio, expressed as a percentage, between its liquefiable assets and its qualifying liabilities, as specified in the Fourth Schedule to the Ordinance.*

102(3) [2] *Assets and liabilities of branches outside Hong Kong shall not be taken into account in the computation of the liquidity ratio.*

102(4) [3] *The minimum percentage limit may be varied by the Financial Secretary by notice in the Gazette.*

105(1) [4] *The percentage limit for a particular AI may also be varied by the HKMA.*

14. Charges over assets

106(1) Has the AI complied with the requirement that the sum total of all amounts secured by way of charge over its assets (excluding contra items) is less than 5% of the sum total of the value of those assets unless the HKMA has approved a higher amount?

Notes:

[1] *This section does not apply to AIs incorporated outside Hong Kong.*

106(2) [2] *The MA may, by notice in the Gazette, specify a charge, or a class of charges, to which the above section shall not apply.*

15. Civil proceedings

106(3) Has the AI any civil proceedings instituted against it which materially affect, or could materially affect, the financial position of the AI and which have not been notified to the HKMA?

Note:

This section does not apply to AIs incorporated outside Hong Kong.

PN 830 (Revised)
Issued January 2005; revised December 2011[] 2014

Effective for financial statements which cover a period
beginning on or after 3 March 2014
Early application is not permitted~~Effective upon issue~~

Practice Note 830 (Revised)

Reports by the Auditor under the Banking Ordinance



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

PRACTICE NOTE 830 (REVISED)

REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE

(Issued January 2005; revised December 2014[] 2014; *Effective for financial statements which cover a period beginning on or after 3 March 2014.*
Early application is not permitted~~Effective upon issue~~)

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PART I – INTRODUCTION

1. In this Practice Note (“PN”) all the sections mentioned below are in respect of the Banking Ordinance (“Ordinance”) unless otherwise stated.
2. The purpose of this PN is to assist the auditor of authorized institutions (“AIs”) in reporting under the Ordinance.
3. This PN provides guidance to members on the reporting responsibilities of the auditor appointed for the purposes of sections 50(1)(c), 59(2), 63(3) and 63(3A). Guidance is also provided on other reports and notifications issued by the auditor, including notification of audit qualifications or adverse statements under section 59A(2)(c), reporting of significant adverse matters and non-compliances under sections 63A and 63B, notification of resignation of the auditor under section 59A(2) and report of factual findings in relation to voluntary revocation of authorization of an AI. These are dealt with in Part II.
4. Guidance on auditor’s ad hoc communications with the Hong Kong Monetary Authority (“HKMA”) under the protection of section 61 is set out in Part III.
5. This PN is not intended to provide detailed guidance on the general audit procedures to be adopted in respect of the audit of the financial statements of an AI and does not apply to other reports provided by the auditor, such as those provided under the Companies Ordinance on financial statements ~~and on the statement of loans to officers~~. Guidance on auditor’s report on financial statements is set out in HKSA 700, “Forming an Opinion and Reporting on Financial Statements” and ~~guidance on auditor’s report on the statement of loans to officers is set out in Practice Note 600.1 (Revised) “Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)”~~.
6. In addition to the reporting responsibilities under the Ordinance, the auditor is required to report to the relevant authorities in accordance with the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance for the purpose of combating money laundering and terrorism. This PN does not provide guidance in this regard.
7. This PN also contains in Appendix 5 a guide to the relevant provisions for the auditor in the Ordinance which were effective as at 31 October 2004. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this PN should be used in conjunction with the legislation.
8. It should be borne in mind that certain expressions used in the Ordinance may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this PN, members will wish to seek legal advice.
9. The term Monetary Authority in the Ordinance refers to a person appointed by the Financial Secretary under the Exchange Fund Ordinance. The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability and is headed by the Monetary Authority. In this PN, the term “HKMA” is used generally to refer to the organization as a whole. The term “Monetary Authority” is used when quoting a specific reference from the Ordinance and in the auditor’s reports under the Ordinance.
10. The PN has been prepared in consultation with the HKMA.

PART II – AUDITOR’S REPORTING RESPONSIBILITIES UNDER THE ORDINANCE

Introduction

11. The auditor is normally appointed by the AI with the approval of the HKMA for the purpose of preparing certain reports under the Ordinance. The Ordinance generally recognizes the auditor as a person appointed by the shareholders of a locally incorporated AI under the Companies Ordinance to report on whether the AI’s financial statements give a true and fair view (“statutory auditor”) or those appointed by the AI to submit a report to the HKMA under section 59(2), 63(3) or 63(3A). Submission of reports by the auditor under the Ordinance (except reporting under section 59(2)) is normally carried out by an AI’s statutory auditor although the HKMA has the right to commission reports from another audit firm where:
- a. such an arrangement can better utilize the knowledge and expertise of different auditor which may be beneficial to the AI; or
 - b. the HKMA has reason to believe that the statutory auditor would not be capable of producing an adequate report, after taking into account:
 - the reputation of the statutory auditor;
 - the quality of reports previously submitted to the HKMA by the statutory auditor;
 - the expertise, knowledge and resources of the statutory auditor; and
 - any potential conflict of interest on the part of the statutory auditor.

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

12. The auditor has a number of reporting responsibilities under the Ordinance. These include:
- a. Regular reports
 - Reporting on specified banking returns (section 63(3)) (see paragraphs 38 to 65 below);
 - Reporting on systems of control over the compilation of banking returns, compliance with specified sections of the Ordinance and maintenance of adequate provision (section 63(3A)) (see paragraphs 66 to 102 below).
 - b. Other reports
 - Ad hoc reporting on internal controls, specific transactions or any other matters (section 59(2)) (see paragraphs 103 to 125 below);
 - Notification of audit qualifications or adverse statements in audit reports on AI’s financial statements (section 59A(2)(c)) (see paragraphs 126 to 128 below);
 - Reporting of significant adverse matters and non-compliances (sections 63A and 63B) (see paragraphs 129 to 137 below);
 - Notification of resignation of the auditor (section 59A(2)) (see paragraph 138 below).
 - c. Under section 50(1)(c), locally incorporated AIs which maintain an overseas branch may need to appoint an auditor, if the HKMA so requires, to report on whether a return or information submitted by them in respect of their overseas branch(es) is correctly compiled, in all material respects, from the books and records of the branch(es).

13. The auditor is also normally requested to furnish a report on voluntary revocation of an AI's authorization to the HKMA in respect of the balance sheet¹, third party deposit liabilities, contingent liabilities and outstanding commitments (see paragraphs 139 to 144 below).
14. The HKMA issues specific completion instructions and guidelines to AIs on the compilation of banking returns and on meeting the provisions of the Ordinance. In its Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance", the HKMA also provides a description of the nature of some of the controls and procedures it expects AIs to have in place to demonstrate adequate controls over compilation of banking returns and compliance with the provisions in the Ordinance. The auditor would have regard to the requirements set out in Supervisory Policy Manual IC-3 in fulfilling the reporting responsibilities under the Ordinance.

General guidance

Types of engagements under the Ordinance

15. The auditor's reporting responsibilities under the Ordinance can generally be categorized as either reasonable assurance engagements, limited assurance engagements, or agreed-upon procedures engagements.
16. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.
17. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.
18. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed, and to report on factual findings. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report would assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

Overview of the reporting process

19. The following are action steps that the auditor would consider in order to discharge the reporting responsibilities under the Ordinance:

- a. *Scoping and planning*

For reporting under section 63(3) and (3A):

- Assemble the engagement team including any necessary specialists;
- Obtain from the AI the terms of reference (normally called a "Letter of Instruction") identifying the banking returns or systems of control to be reported on and the period to be covered;
- Issue a letter of engagement;
- Obtain the relevant banking returns to be reported on from the AI (if applicable);
- Undertake detailed planning and fieldwork.

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

For reporting under section 59(2):

- Obtain the draft scope of review prepared by the HKMA and discuss the nature of the appointment with the AI;
- Seek a meeting with the HKMA (at which representatives of the AI would normally be present) to obtain the background information, including the reasons why the HKMA is requesting the report;
- Where necessary, hold scoping meeting(s) with the HKMA and the AI to further refine the scope;
- Agree the scope and all other matters that are to be recorded in the Letter of Instruction with the AI and the HKMA;
- Obtain from the AI the Letter of Instruction;
- Issue a letter of engagement to the AI, incorporating the Letter of Instruction;
- Undertake detailed planning and fieldwork.

b. Execution

- If requested by the HKMA, or if considered necessary as a result of issues identified whilst conducting the work, arrange discussions or meetings with the HKMA and/or the AI;
- Incorporate the responses of management (obtained in writing) of the AI to the findings in the final report (if this is the agreed means of communicating management's comments to the HKMA);
- For engagements under section 59(2), arrange with the AI and the HKMA to amend or reissue the Letter of Instruction to reflect any significant matters that come to light during the performance of the work and any changes in scope verbally communicated to the AI or the auditor (if necessary).

c. Finalization and reporting

- Finalize the report with the AI's management comments or responses included, where appropriate;
- Obtain a management representation letter from the AI;
- Issue the final report to the AI for submission to the HKMA;
- For reports under section 59(2), if comments from the AI's management on the draft final report were not incorporated into the auditor's report, obtain a copy of the comments sent by the AI to the HKMA;
- Prepare for and attend any tripartite meeting to discuss the report findings (if necessary).

20. The scope of an engagement under section 63(3) or (3A) is normally considered to be relatively routine and standardized and therefore, some of the above action steps may have been addressed previously and can be carried over into the current period engagement.

Engagement acceptance

21. When undertaking an engagement to provide a report under the Ordinance, the auditor would recognize that throughout the process, there are two parties interested in the report - the AI which engages the auditor; and the HKMA, which has required the AI to commission the report. The auditor would manage the expectations of both parties to reduce the risk of misunderstanding.
22. The auditor would ensure that the scope of the engagement is clear, so that the HKMA and the AI agree, accept and understand the areas to be examined, the form of reporting of the overall findings, the content and structure of the report to be provided and the type and extent of procedures to be undertaken. However, it is the responsibility of the HKMA to determine whether the scope of the work specified in the Letter of Instruction is sufficient for its purposes.
23. For reporting under section 59(2), the HKMA recognizes that normally there will be value in holding discussions involving the auditor concerning the proposed assignment in a tripartite meeting (between the AI, the HKMA and the auditor) or, in less usual circumstances, a bilateral meeting (between the HKMA and the auditor only) but is not bound to do so. This discussion can occur when a draft scope has already been prepared by the HKMA and this would form the basis for the discussion.
24. When approached to undertake an engagement to report under the Ordinance and during the discussion of the scope, the auditor would consider the professional skills required to undertake the engagement.
25. In particular, the auditor would need to have knowledge and understanding of the HKMA's regulatory requirements and the statutory provisions relevant to the scope of the engagement. This is necessary in order to understand and evaluate the scope of the engagement at the outset, and to determine the manner in which the findings in the auditor's report would be presented. In addition, the auditor is required to report, in certain circumstances and without delay, direct to the HKMA and therefore would need to be aware of the relevant provisions.
26. The auditor would need to consider whether previous or existing professional relationships could present a conflict of interest in accepting the engagement. If the auditor becomes aware of relationships with the AI which could be construed as a conflict of interest, the auditor would advise the AI and the HKMA of this issue and all parties have to be satisfied that the auditor is appropriately placed to undertake the assignment objectively.
27. The HKMA has indicated that it would take into account the knowledge and expertise of the statutory auditor and the need for a fresh perspective on matters to be examined when deciding whether to nominate or approve the appointment of the statutory auditor or another audit firm.
28. The auditor and the AI would agree on the terms of the engagement, which would be recorded in an engagement letter or other suitable form of written contract. The auditor would follow the guidance set out in HKSA 210, "Agreeing the Terms of Audit Engagements" and agree the terms of the engagement in relation to the auditor's work performed under the Ordinance.
29. Examples of engagement letters are set out in Appendix 3 to this PN.

Reporting considerations

30. Generally, when making a report, the auditor would apply techniques to keep narrative in the report clear, logically structured and concise, such as using bullet points and tables, and relegating detailed elements to the detailed sections and appendices to the report. The auditor would include specific findings such as exceptions, deficiencies, observations or required recommendations (however defined) arising from the work undertaken together with sufficient background information for the HKMA and the AI to understand the context in which the findings are made and their implications.

31. The auditor would need to be aware that specific findings included in the report can form the basis of supervisory or enforcement action by the HKMA. Therefore, it is important that all relevant matters, which are considered material in the circumstances, be included in the report. When evaluating whether and how to report a specific finding, the auditor would need to recognize that materiality for reporting under the Ordinance may be different to that used in the context of an audit of the financial statements of the AI or an assignment undertaken solely for the AI's management. The auditor would take into account the HKMA's interests in its role as a supervisor, for example by considering the findings in the context of: the HKMA's supervisory objectives; requirements set out in the HKMA's Supervisory Policy Manual in relation to the area examined; and the HKMA's reasons for commissioning a report, including any concerns or issues raised during the scoping discussions. It may also be useful for the auditor to discuss and agree with the HKMA and the AI on the materiality threshold so that what would constitute a matter to be reported as a specific finding and how it will be described are clearly understood between all parties.
32. The materiality threshold is a matter of professional judgment but, unless otherwise agreed with the HKMA, the auditor would normally report all relevant matters other than those considered to be immaterial. This PN provides further guidance for the auditor on materiality for the purpose of the reporting responsibilities under the Ordinance (see paragraphs 60, 93 to 97 and 118 to 119 below for different engagements).
33. Unless otherwise agreed with the HKMA, where an auditor's engagement for the purpose of reporting under the Ordinance includes the examination of controls over a specified period or transactions during that period, the auditor would include all material findings identified even if the findings identified were corrected during or after the period examined.
34. The auditor would seek management's confirmation of the factual accuracy of information or statements contained in the auditor's report. This may be achieved either by way of a written confirmation from management or as a specific representation from management included in the management representation letter. Examples of management representation letters are set out in Appendix 2 to this PN.

Obtaining management comments

35. The HKMA expects management of the AI to have the opportunity to provide written comments on the auditor's report prior to its submission to the HKMA. Management may wish to provide the auditor with written comments for incorporation into the auditor's report prior to its issue. Alternatively, management of the AI may choose to provide written comments directly to the HKMA when the AI submits the report to the HKMA.
36. Where the auditor includes management comments in the report prior to its issue, the report would clearly identify the comments of management. The report would also state clearly that the management of the AI is responsible for the accuracy of the comments made, that the auditor takes no responsibility for them and that they are not covered by the auditor's conclusion (or overall findings otherwise provided). A common practice used in the presentation of management letters or internal control reports, which can assist the review of an auditor's report by the HKMA, is to incorporate management comments in the body of the report, against the elements of the report to which the comments relate.
37. Management comments for incorporation in the auditor's report prior to issue would be obtained from, or confirmed in writing by, the AI in order to minimize the risk of error or misunderstanding. Where the auditor issues a report without incorporating management's comments, the auditor would obtain a copy of any comments that management submits directly to the HKMA.

Auditor's report under section 63(3)

General

38. Management of AIs is required by the HKMA to submit a number of returns within an integrated banking statistics system. The HKMA may also require an AI to submit a report, prepared by the auditor, as to whether or not, in the opinion of the auditor, a return submitted to the HKMA is correctly compiled, in all material respects, from the books and records of the AI and, if not so correctly compiled, the nature and extent of the incorrectness. General guidance on the auditor's report on banking returns is provided in the HKMA's Supervisory Policy Manual IC-3.
39. Preparation and submission of the banking returns is the responsibility of the AI's management. The Ordinance makes it an offence for any person who signs any document for the purposes of section 63 which is known or ought to be known to be false in a material particular. Under section 123, it is also an offence for directors, chief executives, managers, trustees, employees and agents of an AI to wilfully deceive by falsifying books and records.
40. The HKMA has emphasized the importance of the banking returns submitted by AIs and can exercise the powers derived from section 63(3) (and section 50(1)(c)) to require AIs to appoint an auditor to examine and report upon the banking returns submitted to the HKMA and any other returns which are used for prudential purposes to enable or assist the HKMA to exercise its duties and functions under the Ordinance. On occasion, the HKMA may require information in addition to the information contained in standard returns. Such information could also fall within the scope of information to be reported upon by the auditor if it is requested by the HKMA under section 63(2).
41. These reporting arrangements are intended to reassure the HKMA about the reliability of the information received from an AI. It will be for the HKMA to determine, in the light of all the information available to it, the type of action, if any, that would be taken for its prudential supervision purposes.

Scope

42. The work that the auditor performs for the purpose of reporting under section 63(3) is a reasonable assurance engagement. The responsibility for correct compilation of returns rests with the management of the AI and the auditor's responsibility is to report on whether the AI's returns are correctly compiled, in all material respects, from the books and records of the AI based on procedures the auditor performed. Reference should be made to Hong Kong Standard on Assurance Engagements (HKSAE) 3000, "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" for details of the standards and guidance on reasonable assurance engagements.
43. Under section 63(3), the HKMA can require particular returns to be reported on by the auditor. It should also be noted that for certain returns, the auditor would normally report only on specified parts of the return. For a locally incorporated AI, the auditor would normally be required to report on:
 - Return of Capital Adequacy Ratio (All parts);
 - Return of Large Exposures (Parts I, II and III, columns 1 – 5);
 - Return of Liquidity Position (Part I); and
 - Certificate of compliance with the Ordinance (Parts I – III).

Overseas incorporated AIs operate in the form of a branch in Hong Kong are not required to maintain a minimum capital adequacy ratio in respect of the branch. Accordingly, the auditor would normally be required to report on:

- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part I); and
- Certificate of compliance with the Ordinance.

The HKMA can require a report on any return or other information submitted to it under section 63(1) and (2) (and section 50(1)(a) and (b)).

44. The returns to be reported on are normally the most comprehensive in the series. That is, where an AI completes a consolidated return, it will be that return which would be reported on. Where it has no subsidiaries, but has overseas branches, it will be the combined return that would be reported on. The HKMA normally selects only one date for the returns to be reported on per year, but may select other returns and dates if it believes the returns are not being completed properly. The date/period will not necessarily coincide with the end of the AI's financial year. The date will be determined by the HKMA retrospectively after the due submission date of the returns concerned.
45. When errors are identified in the returns submitted to the HKMA, AIs would, depending on materiality, make suitable amendments to the returns and re-submit these to the HKMA. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has indicated that the returns to be reported on by the auditor would be the returns originally submitted to the HKMA unless the HKMA specifies otherwise.

Nature of work

46. The work to be carried out for the purpose of reporting under section 63(3) involves agreeing amounts contained in the relevant returns to appropriate records maintained by the AI and checking whether the amounts have been properly compiled based on the completion instructions issued by the HKMA.
47. The auditor would review copies of the following documents when planning the work:
 - a. in respect of locally incorporated AIs, if it is not the statutory auditor, the latest audited financial statements of the AI together with a copy of the latest management letter issued by the statutory auditor where relevant. The auditor would also seek the AI's permission to discuss any matters relevant to the examination with the statutory auditor (for co-operation between auditors);
 - b. all correspondence and all minutes or notes of meetings that the AI has held with the HKMA which are relevant to the auditor's examination of the internal control systems in relation to relevant returns;
 - c. all board and management committee minutes;
 - d. the returns originally submitted to the HKMA or those which the HKMA has specified otherwise, together with any amendments submitted thereafter.

Testing

48. The nature of testing required will vary from AI to AI as this will be dependent on the nature of the systems and processes used to produce the necessary information for compilation of the returns (e.g. whether processes are automated or performed manually).
49. An engagement under section 63(3) requires the auditor to state whether, in the auditor's opinion, the returns have been correctly compiled, in all material respects, from the books and records of the AI. Accordingly, the work the auditor is expected to perform on specified returns normally involves agreeing relevant amounts in the returns to the AI's books and records and ensuring that the compilation procedures were performed in accordance with the completion instructions issued by the HKMA for the relevant returns.
50. The definition of books and records is not specifically set out in the Ordinance. However, the HKMA would expect the information contained in the returns to be consistent with the books and records of the AI. The auditor would consider books and records to include the general ledger (including sub ledgers) and records or reports produced by systems (e.g. loan processing systems) which contain or explain in more specific detail particular items in the

general ledger (e.g. exposures to specific counterparties or a breakdown of balances by maturity buckets) and other records which support particular items in the returns such as off-balance sheet exposures.

51. There is no requirement for the auditor to provide an opinion that the books and records are correct and complete but only that the amounts in the return agree with those books or records. It would normally be sufficient to check all items in the return to the working papers used by the AI to prepare the return and to check, on a sample basis, the compilation of the amounts contained in such working papers to the general ledger. For more detailed information reported in certain returns, it may be test checked to reports generated from established systems which reconcile to the general ledger.
52. In testing for completeness and accuracy, the auditor would also trace on a sample basis the extraction of information contained in the accounting and other records to the relevant returns. Any material adjustments made to the accounting and other records in the course of compiling the returns would be considered for reasonableness. The auditor would also examine the compilation procedures to ensure they are consistent in all material aspects with the HKMA's current completion instructions (including notes and definitions) and any further written rulings that apply specifically to the particular AI.
53. As the auditor's work normally involves testing items on a sample basis, the auditor would consider the adequacy of the compilation process adopted in the preparation of the relevant returns as part of the determination of the sample sizes. For example, the auditor would consider whether the definitions and interpretations used in compiling the information are appropriate, whether the controls are adequate to prevent and identify errors, and whether known issues are taken into account in the compilation process. The auditor would refer to HKSA 530, "Audit Sampling" for further guidance in this regard.
54. On occasion, different interpretations of a particular definition or the requirements of the completion instructions may give rise to different results being reported in the returns. This is important as definitions and requirements set out in the Ordinance and the HKMA's completion instructions are typically worded in a general fashion and management would need to determine how such definitions or requirements would be applied to specific businesses or processes of an AI. Where issues relating to interpretation of the requirements or definition arise, the auditor would consider the following procedures in order to determine whether appropriate interpretation has been adopted:
 - Obtain a detailed understanding of the facts and rationale supporting the interpretation adopted by the AI;
 - Review relevant definitions and interpretations contained in the Ordinance, relevant completion instructions and industry practices;
 - Request that the AI discusses the issue with relevant officials of the HKMA and seeks written clarification thereon which would include the rationale for any conclusions drawn;
 - Consider the need to confirm the interpretation directly with relevant officials of the HKMA;
 - Determine the need to include an appropriate description of the interpretation adopted to form the basis of the opinion within the auditor's report.
55. When evaluating the manner in which a specific finding would be reported, the auditor would take into account the requirements of guidelines issued by the HKMA.

General procedures

56. The general procedures which the auditor would carry out in respect of the work on the examination of returns for the purpose of reporting under section 63(3) include:
- Obtain an understanding of the purpose of the returns and the completion instructions for the relevant returns;
 - Review correspondence between the AI and the HKMA to determine whether specific treatments for reporting items in the returns were agreed and adopted by the AI and whether the HKMA has granted specific exemptions to certain requirements for the particular AI;
 - Ascertain whether the AI is required to prepare a consolidated return and, if so, determine the entities that are to be included by reviewing the relevant instructions or correspondence issued by the HKMA;
 - Test check the calculations on the returns;
 - Test check items from the returns to the working papers used by the AI to prepare the returns;
 - Test check balances from working papers used by the AI to books and records and vice versa;
 - Check that the compilation of amounts in the returns is in accordance with the relevant completion instructions and definitions;
 - Check whether only amounts which meet the relevant criteria are included in specific line items;
 - Reconcile totals to the general ledger where appropriate.

Procedures pertaining to specific returns

57. The auditor would ensure that appropriate procedures are designed and carried out to gain adequate assurance that the returns are compiled correctly from the books and records. The specific compilation procedures of each return would vary depending on the requirements of particular return as set out in the completion instructions and other guidelines issued by the HKMA. The auditor would perform tests on the compilation procedures to determine whether they meet the requirements of completion instructions and relevant guidelines issued by the HKMA. Particular areas which the auditor would take into consideration in examining returns which normally fall within the scope for reporting under section 63(3) are highlighted below for reference purposes:

a. Capital Adequacy

- Check that reserves have been appropriately classified under the categories of “Core capital” and “Supplementary capital”;
- Perform checks as to whether the amounts and nature of items recognized as “Supplementary capital” are in accordance with the limits and any specific guidance on criteria established by the HKMA in the completion instructions and in the HKMA’s Supervisory Policy Manual and other guidelines in respect of “Supplementary capital”;
- Perform checks as to whether the specified items are deducted from the core capital and supplementary capital in accordance with the completion instructions;

- Check that the AI has properly calculated the risk-weighted amount for credit risk, market risk and operational risk in relation to its on- and off-balance sheet exposures as the case requires, taking into account the type of instrument or exposure, the nature of counterparties, the maturity of the exposure and the approach it adopts to calculate the capital requirements for those exposures.

b. Large Exposures

- Obtain an understanding of how the AI captures and reports connected parties and transactions;
- Obtain a list of connected parties (as defined in the completion instructions) and perform procedures to ascertain completeness;
- Perform procedures to gain assurance that counterparties which are connected in a way that the financial soundness of one may affect the financial soundness of another are identified and that exposures to such counterparties are captured and aggregated for reporting purposes;
- Perform sample checks on individual exposure amounts to determine whether on- and off-balance sheet direct exposures are captured and whether indirect exposures (e.g. guarantees granted by the counterparty) are also appropriately identified and reported;
- Perform sample checks as to whether exposure amounts (aggregating all facilities) for individual counterparties or groups of counterparties have been captured on a daily basis and that the maximum exposure is identified from the daily reported exposures;
- Review the nature of counterparties or groups of counterparties and assess the appropriateness of classification within the relevant parts of the return.

c. Liquidity

- Perform sample checks as to whether various types of liquefiable assets and qualifying liabilities have been appropriately classified according to their nature, the remaining term to maturity, and that they qualify for inclusion as liquefiable assets and qualifying liabilities according to criteria set out in the Fourth Schedule of the Ordinance;
- Confirm with the AI whether the HKMA has given approval to the AI to calculate the average monthly liquidity ratio on the basis of specified days during the month and perform checks as to whether the AI calculates the ratio on the basis agreed with the HKMA;
- For the purpose of calculating the lowest liquidity ratio during the month, perform checks as to whether the AI determines the ratio as the lowest liquidity ratio recorded at the close of business on a working day, or specified day and the last calendar day of the month, as the case may be, during the month covered by the return.

d. Compliance

- Check that the capital base reported agrees to the amount reported in the Return of Capital Adequacy Ratio at the previous quarter end*;
- Perform checks on the collateral records maintained by the AI to determine whether the shares of the AI, its holding, subsidiary or fellow subsidiary companies are held as security for loans and other credit facilities;

- Perform checks on compliance with the requirements under sections 80, 81*, 83*, 85, 87*, 87A*, 88*, 90* and 106* during the reporting period;
- Obtain correspondence setting out the minimum capital adequacy and liquidity ratios set by the HKMA for the AI for the purpose of compliance with sections 98* and 102;
- For items 1-7 under Part III of the return, check that daily closing exposures were used in reporting the maximum exposure and that the amount reported excludes those items which were exempted under sections 81, 83, 87 and 88*;
- Check the calculations for the maximum ratio of pledged assets and ensure the amounts used were correctly extracted from the AI's register of charges or other appropriate books and records*;
- Review legal correspondence for civil proceedings which may have a material impact on the financial position of the AI and confirm with management that it has notified the HKMA of any such proceedings*.

** applicable for locally incorporated AIs only*

Representations by management

58. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management's responsibility for establishing and maintaining adequate accounting records and systems of control to ensure that the returns have been correctly compiled from the books and records of the AI and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that all the returns provided to the auditor for the purpose of this engagement are the ones first submitted to the HKMA;
 - c. stating that all transactions undertaken by the AI have been properly reflected and recorded in accounting and any other records and for the compilation of the returns, such records properly reflect the true nature of all transactions;
 - d. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondences with the HKMA, etc.) for the purpose of the auditor's examination of the returns, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
 - e. stating whether there have been any communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the information presented in the returns;
 - f. the returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the HKMA;
 - g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period;
 - h. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report; and

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

Materiality

60. The HKMA only requires errors which are material in amount or indicative of weaknesses in the compilation process to be reported. What constitutes material will need to be judged by the auditor on a case-by-case basis but the focus is on the quality of the statistics provided rather than on minor reporting errors. As a general rule the HKMA has stated in its Supervisory Policy Manual IC-3 that an error should normally be considered material if it exceeds 5% of the applicable item in the return to which it relates. It should also be noted that in addition to quantitative differences on a particular line item, the auditor would also consider the impact of errors in a particular line item on other parts of the return or on other returns subject to examination.

Reporting

61. Each error or exception considered to be material would be reported together with an appropriate description of the error as well as the impact on the relevant return. Such errors would include those identified by the auditor or amendments made by the AI subsequent to the submission of the return under examination.
62. Where exceptions are identified and there is evidence to suggest that weaknesses in internal controls exist, the auditor would also consider including in the report under section 63(3A) the observations and recommendations on the relevant internal controls for the HKMA and the AI to gain a fuller understanding of the implications of the auditor's findings (see paragraphs 98 to 102 below).
63. An identical copy of the returns on which the auditor's report is based would accompany the auditor's report. Errors or exceptions would be set out either within the body of the auditor's report or in an appendix, reference to which is made in the auditor's report.
64. The auditor should carry out a reasonable assurance engagement in accordance with HKSAC 3000 and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. The auditor's report shall state that the engagement was conducted in accordance with HKSAC 3000 and with reference to PN 830. The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within two months from the date of the notification from the HKMA and the AI would forward the auditor's report together with any comments thereon within a further one month. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.
65. Examples of auditor's reports under section 63(3) are set out in Appendix 1 to this PN – Examples 1 and 2.

Auditor's report under section 63(3A)

General

66. It is the responsibility of an AI's directors and management to ensure that adequate systems of internal control are maintained. It is the responsibility of the HKMA to judge whether an AI has maintained adequate systems of internal control as part of its overall assessment as to whether all the criteria for authorization are being met.
67. As a supervisor, the HKMA is concerned with obtaining evidence to enable it to form a view as to whether the prudential requirements on internal control systems are met. The HKMA will do this, inter alia, by considering any evidence provided by the auditor.
68. The HKMA has interpreted the requirements of the Ordinance in various modules of its Supervisory Policy Manual. The auditor would need to be familiar with the contents of the guidance contained in these modules of Supervisory Policy Manual to the extent relevant to the specific examination requested by the HKMA.
69. The HKMA will require AIs to appoint the auditor to report to the directors of a locally incorporated AI or the chief executive of a Hong Kong branch of an overseas incorporated AI whether, in the auditor's opinion, certain internal control systems have been maintained by the AI throughout the period examined in accordance with the requirements of the Ordinance. In forming the opinion, the auditor would have regard, inter alia, to the nature and scale of the business of the AI. The auditor will also be required, after forming an opinion on the specified internal control systems, to report on other matters contained in section 63(3A)(b).
70. An engagement to express an opinion on an AI's systems of control for the purpose of the Ordinance differs in purpose and in scope from a study and evaluation of the systems made as part of an audit of financial statements in order to express an opinion on whether those statements give a true and fair view. Given these differences, the auditor is unlikely to be able to rely solely on the work carried out for the purpose of auditing the financial statements and therefore the auditor would adopt additional procedures for the purpose of reporting under section 63(3A).
71. The scope and period to be covered by the report under section 63(3A) will normally be notified in writing to the AI and copied to the auditor.

Scope

72. The work that the auditor performs for the purpose of reporting under section 63(3A)(a) is an engagement providing reasonable assurance. The responsibility for adequate internal controls rests with the directors and management of the AI and the auditor's responsibility in providing reasonable assurance is to report on whether certain internal controls were in place during the relevant period. Having performed the work, the auditor is then required to report under section 63(3A)(b) on whether the auditor is aware of any material contraventions of certain provisions under the Ordinance by the AI and in addition, for locally incorporated AIs, any failure to maintain adequate provision. This assurance is based not only on the work performed under section 63(3A)(a) but would also take into account any other relevant information which comes to the attention of the auditor in the normal course of the audit work or in the examination of returns under section 63(3). The auditor will not, however, be expected to change the scope of the audit work nor the frequency or timing of the audit visits. Reference should be made to HKSAs 3000 for details on the standards and guidance in this regard.
73. The HKMA is empowered under section 63(3A)(a) to require an AI to submit a report by the auditor on whether, during a specified period, the internal control systems of the AI were adequate to enable, as much as is practicable:
 - a. the AI's returns or information to be correctly compiled, in all material respects, from the books and records of the AI;

- b. the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance;
 - c. in the case of a locally incorporated AI, the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.
74. Having completed the work on the specified internal controls, the auditor would then report under section 63(3A)(b) in respect of the same period on whether:
- a. there appears to be any material contravention by the AI of any of its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance, and, if it so appears, the nature of the contravention and the evidence therefor; and
 - b. in the case of a locally incorporated AI, there appears to have been any failure by the AI to maintain adequate provision.
75. The period covered by a report under section 63(3A) will not normally be more than 12 months unless the HKMA is of the view that a longer period is necessary in the interest of depositors or the public. Usually the period covered will be the financial year. Only one report is required to be submitted under section 63(3A).

Nature of work

76. The nature of the work to be carried out will be to determine whether appropriate internal controls exist and test the effective functioning of such internal controls. Testing would, therefore, be designed to determine whether the control procedures are being performed effectively. It should also be noted that the adequacy of controls would be assessed with reference to Supervisory Policy Manual and guidelines issued by the HKMA and taking into account the nature of business and size of the operation of the AI. For example, if the control being tested was the application of appropriate provisioning levels, the tests of the control may include:
- enquiry of the relevant officer and the supervisor/reviewer to ensure they clearly understand the objective of performing the control procedure;
 - examination of the AI's provisioning policies, procedures and methodologies;
 - assessment of whether the process of determining the level of provision has adhered to the policies, procedures and methodologies;
 - examination of the process to obtain the necessary approvals;
 - re-performance of the calculation or carrying out appropriate estimations on the provision amount; and
 - checking that the provision amount has been properly recorded in the books and accounting records of the AI.

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

77. The auditor would also consider carefully the implications of any examinations performed by the HKMA, internal audit of an AI or other parties on an AI's internal control systems or asset quality. A material finding arising from such an examination can be an indicator of potential issues with the control systems in place and which may form the basis of an exception to be reported under section 63(3A).

Correct compilation of returns and information from books and records

78. The auditor's work in testing the compilation process can be viewed or conducted in conjunction with the work done on specific returns under section 63(3). AIs regularly submit information to the HKMA for statistical and prudential supervision purposes. However, the work performed under section 63(3) is, in practice, only limited to a few key returns in a particular period. Consequently, the HKMA is seeking to gain additional comfort on the reliability of the information submitted in other returns throughout the year by way of an examination of the broader return compilation process of an AI.
79. The HKMA has set out in its Supervisory Policy Manual that AIs should have adequate systems of control to enable the submission of reliable statistics and information to it. The auditor is required under section 63(3A)(a)(i) to report on the effectiveness of the systems of control set up to ensure the correct transfer of information from records to returns. The statistics and information would be complete, accurate and prepared in accordance with completion instructions issued by the HKMA. It should be noted that the systems of control would cover not only periodic returns submitted to the HKMA but also other information such as ad hoc surveys and statistics that the HKMA may request from an AI from time to time under section 63(2). The controls expected to be in place and the type of work that could be undertaken to enable the auditor to report on the effectiveness of controls would include the following:
- a. Controls over data capture for compilation of returns*
- AIs have controls in place to ensure that data that is necessary to enable reporting of information to the HKMA is captured completely and accurately. In most circumstances, reporting to the HKMA would be based on a set of predefined criteria and format. As such, it is important that adequate guidance on data definitions and the data capturing process are made available to responsible personnel so that they acquire a proper understanding of the requirements for data capture.
 - The auditor would perform procedures to assess whether the relevant officers have an appropriate level of understanding of the reporting requirements taking into account the adequacy of guidance available for the purpose of capturing such information.
- b. Understanding of the return compilation process and requirements*
- Persons responsible for compilation of returns from the AI's books and records have an adequate understanding of the regulatory requirements and definitions set out by the HKMA in the relevant completion instructions and how they should be applied in the context of the AI's business and operations. The existence of a procedures manual containing an appropriate level of detail provides a source of reference to officers involved to facilitate their understanding of the compilation process and the procedures that are to be carried out in compiling returns and information. Such a procedures manual would set out the timing of reports, compilation procedures, source of information, and other procedures carried out to collect information to ensure complete, accurate and timely compilation of returns and other information. In addition to a procedures manual, guidelines and instructions and relevant correspondence and discussions between the AI and the HKMA which relate to compilation of returns and information would be maintained, filed and made available to responsible officers for reference purposes.
 - The auditor would consider the adequacy of the processes and information in place to ensure that this understanding is updated for changes in regulatory reporting requirements as well as changes in business or operations. The auditor would also check the documentation of the control systems, and clarify the understanding of the systems with management to confirm the systems operate in the manner recorded.

The auditor is generally expected to perform tests on the effectiveness of these control systems.

c. Maintenance of adequate audit trail

- AIs maintain clear, concise and organized documentation supporting the compilation of returns and other information from the relevant books and records so that there is a clear and traceable link between the underlying records and the completed returns.
- The auditor would carry out procedures to examine such documentation and perform tests as to whether the information contained in the completed returns and other information are compiled from the underlying books and records and seek appropriate explanations on any material errors or discrepancies thereon from management.

d. Process for clarifying issues

- AIs have in place a process whereby questions and issues (e.g. treatment of particular transactions for reporting purposes) that may arise in the course of compiling returns are identified and resolved in an appropriate manner. Such a process would include escalating the issue to appropriate personnel within the AI and where necessary, referred to the HKMA for clarification. All such clarifications would be properly documented and maintained for future reference purposes.
- The auditor would assess any material issues raised and be satisfied that the manner in which such issues were resolved was appropriate and in accordance with the relevant reporting requirements.

e. Review and approval

- Both the Chief Executive and the Chief Accountant or their equivalents are required to sign off on the returns submitted to the HKMA. The sign-off process is supported by adequate review and approval procedures during the course of the compilation. The purpose of such a review and approval process is to enable errors or inconsistencies to be identified and allow corrections to be made prior to the submission of the information to the HKMA. The review and approval procedures are performed by an officer independent of the preparation process and with an appropriate level of understanding of the requirements and how they are applied to the business and operations of the AI.
- The auditor would appraise the review and approval procedures as well as the experience of those responsible for such reviews and assess the adequacy and effectiveness of these procedures by way of observation, re-performance, or inquiry with relevant personnel.

f. Use of computer-based tools and systems

- AIs commonly make extensive use of computer-based tools and systems in their operations and for maintaining their accounting records. Such AIs place significant reliance on the ability of these systems to ensure that information is captured, processed and reported accurately and completely. The use of computer-based systems to facilitate the compilation of returns and other information from books and records of an AI is also increasingly common.
- Where AIs operate computer-based systems to process information used for compiling returns and other information or rely on such systems to automate the compilation process, the auditor would consider assessing the adequacy of controls over such systems.

g. Backup arrangements

- Staff changes can arise due to various reasons including planned and unplanned leave, rotation of duties, resignations, etc. AIs would have in place procedures to ensure that staff changes do not have any adverse impact on the quality of returns and other information or on the timing of their submission to the HKMA.
- The auditor would understand the AI's backup arrangements and assess whether backup staff responsible for compiling returns and other information have an adequate understanding of the requirements and procedures to be carried out.

Compliance with specific provisions of the Ordinance

80. The guidelines issued by the HKMA require AIs to have effective monitoring and reporting systems to enable compliance with their statutory duties under the Ordinance at all times. While this is a general principle which applies to all duties under the Ordinance, the auditor will be asked particularly to report on those controls relevant to the duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII (section 63(3A)(a)(ii)) of the Ordinance. To meet this reporting requirement, the auditor would identify whether appropriate control procedures are in place to enable the AI to comply with its statutory duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance and test whether such control procedures are operating effectively.
81. The types of controls that AIs normally have in place to enable compliance with their statutory duties under the Ordinance at all times include:
- Procedures to ensure that management is fully aware of the relevant statutory provisions and regulatory requirements as they apply to the AI's operations;
 - A repository of information containing the Ordinance, guidelines and circulars issued by the HKMA, communications with the HKMA and any amendments to all such documents is maintained, and procedures to ensure effective communication of such information to relevant personnel in the AI;
 - Formal policies on compliance with the provisions of the Ordinance;
 - Procedures on ensuring compliance with statutory and regulatory requirements in all aspects of the AI's operations are maintained. Such procedures may include setting of appropriate limits and targets, monitoring and reporting transactions against limits and targets, stress testing, etc. These procedures would deal not only with day-to-day operations but also the process of introducing new products and businesses;
 - An officer (such as a compliance officer) designated with the responsibility for monitoring and ensuring compliance with statutory and regulatory requirements;
 - Reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant members of management (including the compliance officer) and actions on non-compliance are taken in a timely manner;
 - Procedures for reporting any compliance failure to the HKMA in a timely manner are established;
 - The monitoring of compliance is supported and evidenced by clear, concise and organized documentation to provide an audit trail for subsequent verification.
82. Part XII of the Ordinance deals with the requirements to disclose information to the HKMA, and the auditor's reporting responsibilities in this regard are addressed in the work on examining the AI's control systems for the correct compilation of returns or information from the books and records.

83. A report for the purpose of section 63(3A) also requires the auditor to conclude on whether adequate controls are in place to enable compliance with the following provisions of the Ordinance:

- Part XV – Limitations on loans by and interests of AIs
- Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)
- Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio

84. The types of controls which are normally in place in the AI to enable compliance with the above provisions and which the auditor would take into account in designing the procedures include:

a. Part XV – Limitations on loans by and interests of AIs

- Written policy in respect of taking of own shares as security, large exposures and advances to connected parties, shareholdings in other companies and interests in land;
- Establishment of appropriate internal limits (within the statutory limits under the Ordinance) for individual customers and groups of related customers, shareholdings and interests in land and sub-limits for various business units, branches or subsidiaries;
- Process for identifying and reporting breaches against internal limits to senior management on a continuing basis;
- Timely reporting of positions and exposures to management to enable appropriate actions to be taken;
- A system to capture all up-to-date financial exposures to a particular customer or group of related customers, irrespective of whether they are exempted or not;
- Procedures to ensure that compliance checks are performed prior to approval of facilities;
- Procedures to enable the terms and conditions for exemptions granted by the HKMA on exempted exposures to be monitored and complied with on an ongoing basis.

b. Part XVII – Capital adequacy ratio of AIs (for locally incorporated AIs only)

- Written policy on the AI's strategy on maintaining capital adequacy for the purpose of both its business activities and to meet regulatory requirements;
- Establishment of target capital ratios which are above the minimum required for business or regulatory purposes;
- Process for identifying and reporting breaches against target ratios to senior management on a continuing basis;
- Budgets prepared to take into account capital adequacy requirements and changes in capital adequacy as a result of projected asset mix, balance sheet growth and capital resources;
- Capital adequacy ratios are calculated and reported to management on an ongoing basis;

- Procedures on assessing impact of large loans, investments or other significant transactions on capital adequacy prior to the transaction taking place;
- Stress-tests are performed on capital adequacy ratio on a regular basis.

c. Part XVIII – Liquidity ratio of AIs and matters affecting the liquidity ratio

- Written policy on the AI's strategy and procedures for maintaining adequate liquidity at all times to meet business and regulatory requirements;
- Target ratios for liquidity and maturity mismatch (if any) which are above the minimum regulatory requirements are set and procedures are in place to identify and immediately report breaches or exceptions to senior management;
- Procedures are in place to allow liquidity and maturity mismatch ratios to be reported and monitored on an ongoing basis;
- Procedures on assessing impact of large loans, investments or other significant transactions on liquidity prior to the transaction taking place;
- Contingency plans are in place for coping with various types of liquidity crisis;
- Stress-tests are performed on the liquidity position on a regular basis.

85. A checklist of questions concerning compliance with Part XII, XV, XVII or XVIII of the Ordinance is set out in Appendix 7 to this PN.

86. Other procedures that the auditor may consider in assessing controls to ensure compliance with Parts XV, XVII and XVIII are set out in the HKMA's Supervisory Policy Manual IC-3, Annex B.

Maintenance of adequate provision

87. For locally incorporated AIs only, the auditor is required to report on whether or not, during the period, the AI had in place systems of control which were adequate to enable it, as much as is practicable, to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur, and if those systems were not adequate the nature and extent of those inadequacies.

88. Maintenance of adequate provision is one of the key criteria for maintaining an authorization and for many AIs, an area of particular focus by management. The HKMA has also issued guidelines on loan classification and provisioning requiring AIs to have adequate policies and procedures for the regular appraisal of the quality of their assets and for the establishment of adequate provision for bad and doubtful debts.

89. The auditor, as part of the statutory audit may have performed certain procedures relating to the maintenance of adequate provision and the work required to comply with the statutory reporting duties under this section may be an extension of the work performed for statutory audit purposes.

90. The types of controls AIs would normally maintain to ensure that they meet the objective of maintaining adequate provision include:

- Written policies and procedures setting out the frequency of review, methodology and level of provision to be maintained for each class of exposure (e.g. on- and off-balance sheet);

- An appropriate loan classification system with clear definitions (both qualitative and quantitative measures) for each class of exposures to allow monitoring of asset quality on a regular basis;
- Minimum provision levels are set and observed for each class in the classification system;
- Responsibilities for reviewing and approving provision are clearly allocated to officers or committees with sufficient authority;
- The credit process includes procedures for:
 - monitoring of asset quality and concentration risks by country and sector;
 - monitoring of adverse economic or political factors which may have an effect on asset quality or borrowers' repayment ability;
 - monitoring of overdue, rescheduled or over-limit assets;
 - reviewing irregularities in individual credit exposures;
 - reviewing the borrowers' and guarantors' financial position;
 - reviewing and updating the value of collateral on a regular basis.
- Procedures are carried out to review and assess the level of provision on a regular basis;
- Provisioning decisions are recorded, documented and reported to senior management, an appropriate committee and to the Board on a regular basis;
- Procedures are carried out to review the value of assets on a regular basis (such as fixed assets, investments and other assets) to assess whether impairment or loss exists;
- Procedures are in place to identify and determine an appropriate level of provision for liabilities including assessments of whether contingent liabilities should be recognized as liabilities on the balance sheet (e.g. litigation cases).

Representations by management

91. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:
- a. acknowledging management's responsibility for establishing and maintaining the systems of internal control and that the AI complies with the provisions of the Ordinance at all times;
 - b. stating that management has disclosed to the auditor all material weaknesses in the internal control systems of which it is aware and also those areas for which management believes the cost of corrective action may exceed the benefits;
 - c. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondence with the HKMA, etc.) for the purpose of the auditor's examination of the internal control systems, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;
 - d. describing any irregularities involving management or employees who have significant roles in the systems of internal control;
 - e. stating whether there were any changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses;

- f. stating whether there have been communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the returns;
 - g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance during the relevant period;
 - h. for locally incorporated AIs only, confirming that the AI has maintained adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses during the relevant period;
 - i. for registered institutions, confirming that the AI has complied with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (see paragraphs 129 to 137);
 - j. confirming that management is not aware of any matters which would adversely affect the financial position of the AI to a material extent; and
 - k. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report.
92. An example management representation letter is set out in Appendix 2 to this PN – Example 2.

Materiality

93. An exception which would be reported for the purpose of a report under section 63(3A) would relate to either:
- a material weakness in controls over (i) compilation of returns and other information, (ii) compliance with certain provisions of the Ordinance, and (iii) maintenance of adequate provision;
 - an actual contravention of the Ordinance; or
 - inadequate provision.
94. The auditor would exercise judgment on whether a weakness or failure in the control systems is material taking into account the impact such a weakness or failure may have on the quality of the reported information, the ability of the AI to comply with relevant provisions of the Ordinance and to maintain adequate provision. In respect of an overseas incorporated AI, it is a weakness or failure in the control systems which is material in the context of the AI's operations in Hong Kong which would be reported.
95. Considerations on materiality in the context of reporting under section 63(3A) are wide ranging and vary depending on the nature, size and complexity of the AI concerned. Whilst an actual contravention of the Ordinance is generally a factual matter, what is considered to be material for the purpose of reporting on controls and adequacy of provision requires the exercise of judgment in the context of the AI concerned. The auditor would perform adequate procedures to confirm existence and effectiveness of controls on areas which, in the auditor's judgment, are material with respect to the AI.
96. The auditor would normally be required to report separately under section 63(3) on whether specific returns were compiled based on the AI's books and records. Errors or exceptions (whether material or not) identified in the course of the auditor's work for the purpose of section 63(3) are prima facie evidence that there may be an internal control weakness in the

compilation process. Therefore, the auditor would consider carefully the underlying reasons leading to such errors and assess the implications on the work under section 63(3A).

97. When evaluating the manner in which a specific finding should be reported, the auditor would take into account the requirements of Supervisory Policy Manual and guidelines issued by the HKMA and any potential impact on the AI's financial position.

Reporting

98. The auditor's report under section 63(3A) is a report on both the existence of appropriate controls and whether such controls have operated effectively during the specified period. The opinion in the auditor's report under section 63(3A) is structured into two main parts. The first part is an opinion for the purpose of section 63(3A)(a) on whether controls are in place to enable:

- the AI to correctly compile from its books and records, in all material respects, the returns and other information, which are required to be submitted to the HKMA;
- the AI to comply with its duties under Parts XII, XV, XVII (for locally incorporated AIs only) and XVIII of the Ordinance; and
- the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur (for locally incorporated AIs only).

The second part is an opinion for the purpose of section 63(3A)(b) given on the basis of the work performed under section 63(3A)(a), on whether the auditor was aware of:

- any instances where the AI has materially contravened any of its duties under Part XII, XV, XVII (for locally incorporated AIs only) or XVIII of the Ordinance; and
- for locally incorporated AIs, any instances where the AI has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

99. The opinion in respect of section 63(3A)(b) is drawn from the work performed under section 63(3A)(a). However, the HKMA would expect the auditor to take into account any other information which comes to the attention in the capacity as the auditor of the AI, including any information obtained from the normal course of any audit work performed and in the auditor's examination of specific returns under section 63(3).

100. An appropriate description of any weakness or failure in the control systems considered to be material would be reported together with the auditor's recommendations for improvement where possible.

101. The auditor should carry out a reasonable assurance engagement in accordance with HKSAE 3000 and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 and with reference to PN 830. The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within three months from the end of the specified period and the AI would forward the auditor's report together with any comments thereon within a further one month.

102. Examples of auditor's reports under section 63(3A) are set out in Appendix 1 to this PN – Examples 3 and 4.

Ad hoc reports under section 59(2)

General

103. The HKMA has discretionary power under section 59(2) to require an AI, after consultation with the AI, to provide an auditor's report on any matters the HKMA may specify which are relevant for the exercise of its functions. This power enables the HKMA to require an AI to appoint the auditor to report on internal controls, specific transactions, or any other matters which are relevant for the performance of its functions under the Ordinance.
104. A report under section 59(2) is commissioned on an ad hoc basis. The circumstances which can lead to a decision by the HKMA to commission such a report generally relate to the identification of issues or events which pose a significant adverse risk to the AI's financial position, business or operations, or represent a threat to the interest of depositors or stability of the banking sector. Such issues or events can arise from:
- significant internal control weaknesses raised in management letters from the AI's auditor;
 - issues arising from reviews by the HKMA or internal auditors;
 - frequent errors in returns submitted to the HKMA;
 - occurrence of an adverse event (e.g. fraud) affecting the AI;
 - significant exposures to certain high risk business activities.
105. As set out in the HKMA's Supervisory Policy Manual IC-3, the HKMA can also require a report to be commissioned on the financial affairs of the AI, based on an audit of its financial statements, if the HKMA has reason to believe that the normal audit carried out by the auditor was, or is likely to be, deficient.
106. The AI's statutory auditor may be appointed for the purposes of reporting under section 59(2). Even where there are no doubts about the capability of the statutory auditor, the HKMA has the right to require that a report under section 59(2) be obtained from another audit firm to obtain a fresh perspective on matters which are the subject of the report.
107. The extent of the detail included in the auditor's report concerning the description of the relevant internal controls and of the procedures undertaken to test the operation of those controls to support the conclusion provided is a matter of judgment for the auditor. The auditor would have regard to the expectations of the HKMA and the AI and would evaluate the risk of misinterpretation or misunderstanding in this regard.
108. The auditor would seek to ensure that the extent of the description of the relevant internal controls to be included in the report and the extent of the procedures to be undertaken is specified in the Letter of Instruction issued by the AI. Similar principles apply to any other engagement requiring the exercise of significant judgment.

Scope

109. Due to the fact that a section 59(2) report is commissioned on an ad hoc basis, the HKMA would consult with the AI and the auditor on the scope of work and agree in advance on the terms of reference prior to issuing a notification in writing to the AI requiring such a report.
110. During the discussion with the HKMA and the AI regarding the scope to be covered in the ad hoc review, the following factors would be taken into account:
- Exact scope (including any specific concern) that the HKMA would like to be covered in the ad hoc review;
 - Agreed assurance and materiality level;

- Specific areas of concern that the HKMA would like the auditor to cover in the ad hoc review;
 - Specific guidelines on format of deliverables, including level of assurance required from the auditor.
111. The period to be covered by a report under section 59(2) will vary depending on the circumstances, but the HKMA has indicated that it will not normally exceed 12 months. Factors to be taken into consideration in determining the period to be covered include whether:
- there is enough evidence of policies, controls and records available in the period (for example, whether relevant senior management meetings will have taken place); or
 - changes are expected in the area(s) to be examined (for example in systems, processes, management or products). If so, the auditor would determine whether the auditor's report is intended to reflect the position before, after or during the change period.
112. In certain circumstances, the auditor might be unable to assess the proposed scope sufficiently without a greater understanding of the AI's operations in the area to be examined – for example the organizational structure, product profiles or volumes of transactions. This can arise where the auditor is not the AI's statutory auditor or the scope relates to an area that is not covered extensively by statutory audit work. In these circumstances, the auditor may wish to agree with the HKMA and the AI that a short initial visit to the AI be undertaken before the final scope of the work is agreed. This would enable the auditor to assist the HKMA in refining the scope more effectively.
113. Where applicable, the auditor would agree with the HKMA and the AI on which of the AI's legal entities, divisions, or businesses the report would cover.
114. The auditor's report would normally be submitted to the AI within a period of three months from the date of the notification letter issued by the HKMA and forwarded to the HKMA together with comments from the AI within a further month. The reporting deadline can be varied at the discretion of the HKMA to take into account special circumstances after consultation with the AI and the auditor concerned.

Nature of work

115. The work that the auditor performs for the purpose of reporting under section 59(2) would vary depending on the circumstances surrounding the commissioning of such a report and the subject matter. As such, the engagement can be a reasonable or limited assurance engagement or an engagement to perform agreed-upon procedures or others.
116. For reasonable or limited assurance engagement, the auditor should consider to conduct the work in accordance with HKSAE 3000. The auditor would seek to develop and establish suitable criteria for the engagement based on specified modules of Supervisory Policy Manual or guidelines issued by the HKMA. The modules of Supervisory Policy Manual or guidelines issued by the HKMA used would be agreed in advance. The determination of whether the engagement provides reasonable assurance or limited assurance would depend on the level of assurance required in the circumstances of the engagement. For agreed-upon procedures engagement, the auditor should perform the engagement under HKSRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information".
117. Paragraph 116 only provides reference for the auditor and it is not served to limit the appointed auditor's professional judgment and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Materiality

118. Given the varying nature of ad hoc reviews under section 59(2), the auditor would ensure that clear reference points have been agreed with both the AI and the HKMA to determine the level of assurance that can be provided under given terms of reference. For some engagements, the terms of reference can be expressed in terms of one or more HKMA's and / or other requirements. Some terms of reference are highly specific, quantitative and objective and therefore readily capable of reliable and consistent measurement and interpretation. Some terms of reference are general, qualitative and highly subjective. Others may fall between these two extremes.
119. In order to assess fully the level of assurance that is appropriate concerning general, qualitative, subjective terms of reference, the auditor, where necessary, would assist the HKMA and the AI to prepare, a set of specifically developed criteria which are more capable of reliable and consistent measurement and interpretation in light of the requirements of the HKMA. In many cases, reference can be made to Supervisory Policy Manual and guidelines issued by the HKMA and other pronouncements which set out in sufficient detail the assessment criteria to support an assurance engagement. However, the HKMA remains responsible for determining whether the specifically developed criteria meet its purposes for commissioning a report.

Reporting

120. The auditor would consider whether it is necessary to provide in the report an introductory or background section to set in context the conclusion (or overall findings otherwise reported).
121. Such background information is relevant to the area examined in the report and can include, for example, a description of the organization in that area, the main business lines, the profile of the business and the market significance in the sector and the description of the procedures undertaken.
122. Detailed narrative reports are normally necessary in order to communicate properly the judgments made, the reasons underpinning those judgments and the context in which a conclusion is provided. The implications for the auditor are that a report covering internal controls includes, inter alia, comparatively detailed descriptions of:
- the elements of the design and operation (as applicable) of the internal control systems that are subject to evaluation; and
 - the extent and nature of the procedures undertaken to gain assurance that the internal controls specified operate as prescribed (if part of the scope).
123. The description of the procedures undertaken includes, where appropriate, such matters as details of documents examined, persons interviewed and tests of detail performed.
124. The auditor would attach a copy of the engagement letter and the Letter of Instruction from the AI as appendices to the auditor's report.
125. An example of a report under section 59(2) is set out in Appendix 1 to this PN – Example 5.

Notification of audit qualifications or adverse statements under section 59A(2)(c)

126. Under section 59A(2)(c), the auditor of an AI appointed under section ~~434-395, 396, 397 or 398~~ of the Companies Ordinance is required to provide written notice to the HKMA if the auditor decides to include in the audit report on the AI's financial statements any qualification or adverse statement as to a matter mentioned in section ~~441-406 or 407~~ of the Companies Ordinance.

127. The issue of a qualified audit report or an adverse statement in relation to a matter under section ~~444~~406 or 407 of the Companies Ordinance may have a potentially significant impact on the AI concerned and have to be communicated to the HKMA as soon as reasonably practicable. Except for matters required to be reported under sections 63A and 63B, the auditor would normally be expected to discuss with the AI any matter about which the auditor is concerned, and request that the AI draws the matter to the attention of the HKMA. Nevertheless, it is important for the auditor to strike a balance between preserving the professional relationship with the AI, the possible impact on depositors' interests arising from a delay in reporting and the need to take appropriate legal advice in deciding whether to report such an issue via the AI or directly to the HKMA. In relation to a qualification or an adverse statement, the auditor would take into account the severity of the matter as well as the AI's response to the auditor's request to communicate the matter to the HKMA.
128. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has set out examples of the circumstances where it believes management of the AI should not be informed in advance in the interest of protecting depositors and the auditor should report directly to the HKMA after considering appropriate independent legal advice. The auditor would make reference to these examples in assessing the circumstances surrounding the qualification of the audit report on an AI's financial statements or an adverse statement in connection with a matter under section ~~444~~406 or 407 of the Companies Ordinance.

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

129. Sections 63A and 63B require AI's auditor to submit a report to the HKMA if the auditor becomes aware of any matter in the course of performing the duties as the auditor that in the auditor's opinion:
- Adversely affects an AI's financial position to a material extent (section 63A); or
 - Constitutes on the part of an AI that is a registered institution under the Securities and Futures Ordinance ("SFO") a failure to comply with certain provisions or rules made under the SFO (section 63B).
130. Matters which are required to be reported under sections 63A and 63B have to be reported by the auditor in writing directly to the HKMA as soon as is reasonably practicable. There is no specified format for such a report but the report would cover the nature of the matter and the reasons why the auditor is of the opinion that the matter should be reported.
131. Section 63A requires the auditor which is appointed under section 59(2), 63(3) or 63(3A) of the Ordinance or section ~~395, 396, 397 or 398~~395, 396, 397 or 398 of the Companies Ordinance to report to the HKMA if the auditor becomes aware of a matter which, in the auditor's opinion, adversely affects the financial position of an AI to a material extent. The auditor would consider any such matter which comes to the auditor's attention in the context of the AI as a whole. In relation to an overseas incorporated AI, the requirement of section 63A applies to its principal place of business in Hong Kong and its local branches and as if the principal place of business in Hong Kong and those branches were collectively a separate AI.
132. Some of the matters which the HKMA would expect to be reported under section 63A include the following:
- whether the AI's status as a going concern is questionable (e.g. a material loss that may threaten the financial condition of the AI);
 - whether the AI's capital adequacy ratio has dropped, or will drop, significantly to a level which may be detrimental to depositors;
 - whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.

133. As matters which are reportable under section 63A relate to the financial position of AIs, the auditor is expected to take into consideration potential issues that may constitute a reportable matter under this section in the course of performing the work on AI's financial statements or for the purpose of reporting under section 59(2), 63(3) or 63(3A).
134. Under section 63B, when the auditor becomes aware of a matter that, in the auditor's opinion, is a matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the SFO (a "reportable matter"), the auditor shall, as soon as practicable after the auditor becomes aware of the matter, submit to the HKMA a report in writing on the matter.
135. A reportable matter in respect of AIs refers to a matter that, in the auditor's opinion constitutes on the part of the AI a failure to comply with any prescribed requirement. Prescribed requirement refers to the requirements of any rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO. However, it should be noted that section 63B specifically excludes the requirements under section 149 of SFO in relation to holding of client monies.
136. The HKMA has recognized that there is no obligation for the auditor to specifically perform work or to change the scope, nature and depth of the work to identify non-compliance with the requirements of the SFO where such work does not already form part of the procedures carried out for the purpose of an audit on the AI's financial statements, or for the purpose of reporting under section 59(2), 63(3) or 63(3A). Therefore the auditor is not required to actively seek out grounds for making a report under section 63B and it is only when the auditor becomes aware, in the ordinary course of the work, of a reportable matter that the auditor would make a report to the HKMA.
137. A summary of the relevant regulations and requirements issued by the SFC that the auditor would have to be familiar with for the purpose understanding and fulfilling the duties under section 63B is set out in Appendix 6 to this PN.

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

138. Section 59A(2) requires the auditor of AIs appointed under section 395, 396, 397 or 398~~434~~ of the Companies Ordinance to provide written notice to the HKMA if the auditor resigns before the expiration of the term of office (section 59A(2)(a)) or if the auditor does not seek to be re-appointed (section 59A(2)(b)). Such a written notice is required to be provided to the HKMA immediately.

Report of factual findings in relation to voluntary revocation of authorization

139. In an application for voluntary revocation of the authorization of an AI, the HKMA would require the AI to furnish a report by its auditor in respect of the balance sheet, third party deposit liabilities, contingent liabilities and outstanding commitments. This report would help satisfy the HKMA that the interests of the AI's depositors are or will be adequately safeguarded when the AI's authorization is revoked. The HKMA may provide a copy of the report to the Financial Secretary of the Hong Kong Special Administrative Region Government for the purpose of section 22(1).
140. A report by the auditor of factual findings in relation to a voluntary revocation of the authorization of an AI is an agreed-upon procedures engagement. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work. Reference would be made to HKSRS 4400 for details on the standards and guidance in this regard. An example engagement letter for a report of factual findings in relation to voluntary revocation of authorization is set out in Appendix 3 to this PN – Example 3.

141. The report of factual findings by the auditor is prepared based on specified procedures which would include the following matters:
- a. Whether the AI had any outstanding third party deposit liabilities according to the general ledger and customers deposit records of the AI as at a specified date, and whether this is consistent with the information in the management representation letter;
 - b. Whether the balance sheet as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the management representation letter; and
 - c. Whether the summary of contingent liabilities and outstanding commitments as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the board minutes and the management representation letter.
142. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management confirming, inter alia, the following areas as at the specified date for the purpose of the report:
- a. the accuracy and completeness of third party deposit liabilities of the AI;
 - b. the balance sheet was in agreement with the AI's books and records; and
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments.
143. An example management representation letter is set out in Appendix 2 to this PN – Example 3.
144. The report of factual findings is prepared in accordance with HKSRS 4400. A copy of the balance sheet of the AI and a summary of contingent liabilities and outstanding commitments (or a nil report if there are no contingent liabilities and outstanding commitments) as at the specified date would be attached to the report. An example of the report is set out in Appendix 1 to this PN – Example 6.

PART III – PROTECTION FOR THE AUDITOR ON COMMUNICATIONS WITH THE HKMA

145. Section 61 permits the auditor, notwithstanding any duty which the auditor may owe to the clients (e.g. confidentiality), to communicate to the HKMA, provided that:
- the communication, whether or not in response to a request by the HKMA, is in good faith; and
 - the information so disclosed relates to information or opinion on a matter of which the auditor becomes aware in the capacity of the auditor and which is relevant to any function of the HKMA under the Ordinance.
146. The protection covers not only the auditor appointed under section ~~395, 396, 397 or 398~~⁴³⁴ of the Companies Ordinance but also the auditor appointed for the purpose of sections 50(1)(c), 59(2), 63(3) and 63(3A). It also covers the auditor who makes a report to the HKMA under sections 63A and 63B.
147. The protection afforded by section 61 is general and not restricted by the circumstances in which the information is obtained or by its sources. Provided the information becomes known to the auditor in the capacity as the auditor of an AI, they may communicate that information to the HKMA notwithstanding that:
- the information does not relate to the auditing work undertaken by the auditor; or
 - the source of the information was not the AI.
148. Section 61 does not of itself require the auditor to change the scope, nature and depth of the audit work and the auditor is not required to actively seek out grounds for making a report under this section.
149. Appendix 4 to this PN contains further guidance on ad hoc reports under section 61 that has been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61. Section 61 does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

APPENDIX 1 Examples of reports by the auditor

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

SECTION 63(3) REPORT BY THE AUDITOR TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Return of Capital Adequacy Ratio of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* as at [date];
- ii. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [date];
- iii. Part I of the Return of Liquidity Position of the [*Institution and all its subsidiaries*]* [*Institution and certain of its subsidiaries set out below*]* [*Institution and its subsidiaries other than those set out below*]* [*Institution on a consolidated basis*]* [*Institution’s offices in Hong Kong*]* for the month of [month/year]; and
- iv. Parts I - III of the Certificate of Compliance of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [date].

[The subsidiaries referred to in i., ii., iii. and iv. above are as follows:]*

Respective responsibilities of the directors and auditor

As the directors of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.² These procedures do not represent an audit of the books and records of the Institution.

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 830, “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

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

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Use of this report

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

ABC & Co.

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

Hong Kong

[Date]

* Delete where not applicable

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

SECTION 63(3) REPORT BY THE AUDITOR TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether certain returns of XYZ Bank’s Hong Kong Branch(es) (the “Institution”) as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns (“Returns”) and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

- i. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution for the quarter ended [*date*];
- ii. Part I of the Return of Liquidity Position of the Institution for the month of [*month/year*]; and
- iii. The Certificate of Compliance of the Institution for the quarter ended [*date*].

Respective responsibilities of the chief executive and auditor

As the chief executive of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

It is our responsibility to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.³ These procedures do not represent an audit of the books and records of the Institution.

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 830, “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Conclusion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

³ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Use of this report

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

ABC & Co.

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

Hong Kong
[Date]

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

SECTION 63(3A) REPORT BY THE AUDITOR TO THE DIRECTORS OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period:

- i. there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- ii. it appears that the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Respective responsibilities of the directors and auditor

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.⁴

⁴ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems 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 830, "Reports by the Auditor Under the Banking Ordinance" ("PN 830") issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, in all material respects, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period,
 - i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

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

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. The situation where the auditor has no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*
- ii. The situation where the auditor has some reservation(s) about the institution's systems of internal control but has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*
- iii. The situation where the auditor has severe reservations about the institution's systems of internal control, and has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

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

SECTION 63(3A) REPORT BY THE AUDITOR TO THE CHIEF EXECUTIVE OF THE HONG KONG BRANCH(ES) OF XYZ BANK

Pursuant to section 63(3A) of the Banking Ordinance (the “Ordinance”), we have been requested to report on whether or not, during the period from [date] to [date] (the “relevant period”) XYZ Bank’s Hong Kong Branch(es) (the “Institution”) had in place systems of control which were adequate to enable, as much as is practicable:

- i. the Institution’s returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;
- ii. the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance

in accordance with the requirements specified in Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period, there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV and XVIII of the Ordinance.

Respective responsibilities of the chief executive and auditor

As the chief executive of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

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

It is our responsibility to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.⁵

Basis of conclusion

We conducted our engagement for the examination of relevant internal control systems 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 830, “Reports by the Auditor Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants.

In respect of our examination of relevant internal control systems, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

We have performed such procedures as we considered necessary for the purpose of reporting in accordance with the above requirements.

⁵ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1. in our opinion, in all material respects, during the relevant period,
 - Option (i)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and
 - Option (ii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3 with the exception of the matters set out in the appendix to this report; and
 - Option (iii)** the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3 for the reasons set out in the appendix to this report; and
2. during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.

[with the exception of those matters set out in the appendix to this report.]

Use of this report

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

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [Date]

* *The above example includes three alternative forms of specimen wording for the conclusion section (1) which cater for the following situations:*

- i. The situation where the auditor has no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion].*
- ii. The situation where the auditor has some reservation(s) about the institution's systems of internal control but has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is not pervasive; in this situation, option (ii) would be adopted [an opinion qualified by exceptions].*

- iii. The situation where the auditor has severe reservations about the institution's systems of internal control, and has formed the view, on the basis of the evidence which the auditor has seen, that the weakness is pervasive; in this situation, option (iii) would be adopted [an adverse opinion].*

Example 5 – Section 59(2) report

It should be noted that the scope and content of a report under section 59(2) would vary depending on the purpose and requirements of the HKMA in commissioning such a report. The example below focuses on a review of internal control systems and is only intended to provide an illustration of how such a review report could be structured and presented but other forms of presentation may be appropriate subject to discussion and agreement with the AI and the Monetary Authority. The precise details of the report should be suitably modified to suit individual circumstances.

**SECTION 59(2) REPORT BY THE AUDITOR
TO [Appropriate Addressee] OF XYZ BANK**

In accordance with our engagement letter dated [date] (“Engagement Letter”), a copy of which is attached as Appendix [] to this report, we have carried out an engagement under section 59(2) of the Banking Ordinance (the “Ordinance”) in relation to matters specified in the Letter of Instruction issued by XYZ Bank (the “Institution”) dated [date].

Scope

The scope of our engagement is set out in the Letter of Instruction which requires:

1. a review of the internal control systems of the Institution which were in existence during the period from [date] to [date] (the “review period”) against the requirements set out in the following modules of Supervisory Policy Manual (“SPM”), guidelines and circulars issued by the Monetary Authority:

[list of all relevant modules of SPM, guidelines and circulars issued by the Monetary Authority]
2. *[set out other specified areas of review as appropriate]**

Respective responsibilities of the directors and auditor

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems which comply with the requirements of the Ordinance, and SPM, guidelines and circulars issued by the Monetary Authority. In fulfilling that responsibility, estimates and judgment must be made to assess the expected benefits and related costs of management information and of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that banking risks are properly monitored and evaluated and that transactions are executed in accordance with established authorization procedures and are recorded properly, to enable you to conduct the business in a prudent manner.

It is our responsibility to perform an engagement in accordance with the Engagement Letter addressing the scope set out in the Letter of Instruction and report on:

- a. whether we are aware of any matters which may indicate that the Institution has not established and maintained controls in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and
- b. *[set out responsibilities for other specified areas of review as appropriate]**.

based on the results of the procedures performed by us.⁶

⁶ Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 “Auditors’ Duty of Care To Third Parties and The Audit Report”.

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 830, “Reports by the Auditor Under the Banking Ordinance” (“PN 830”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) for the purpose of reporting on whether relevant internal control systems of the Institution were established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority.

In respect of [*other specified areas of review*], [our engagement was conducted in accordance with [*Hong Kong Standard on Assurance Engagements 3000*]* [*Hong Kong Standard on Related Services 4400 “Engagements to Perform Agreed-Upon Procedures Regarding Financial Information”*]* and with reference to PN 830 issued by the HKICPA.]⁷

We have performed such procedures [*as we considered necessary for the purpose of reporting in accordance with the above requirements*]* [*as were agreed and set out in the Engagement Letter*]*.

Inherent limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing, [with the exception of the matters set out in the Findings and Recommendations Report]:

1. having regard to the nature and scale of the business of the Institution, during the review period, nothing has come to our attention that causes us to believe that the Institution’s internal control systems were not established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and
2. [*conclude on other specified areas of review as appropriate*].

Findings and recommendations

The findings and recommendations arising from our review of the internal control systems are set out in Appendix [] to this report.

Use of this report

This report is for the information of the Institution and its Board of Directors in dealing with the matters set out in the Letter of Instruction dated [*date*] and for submission to the Monetary Authority. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
 Certified Public Accountants (Practising) [or Certified Public Accountants]
 Hong Kong
 [*Date*]

* *Delete where not appropriate*

⁷ This is for reference only and is not served to limit the appointed auditor’s professional judgement and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Example 6 – Report of factual findings in relation to voluntary revocation of authorization**REPORT OF FACTUAL FINDINGS IN RELATION TO XYZ'S APPLICATION FOR VOLUNTARY REVOCATION OF ITS AUTHORIZATION AS A [DEPOSIT-TAKING COMPANY / RESTRICTED LICENCE BANK / BANK]***

In accordance with your Letter of Instruction dated [date], a copy of which is attached, we have performed the procedures below with respect to XYZ (the "Institution"). Our engagement was conducted in accordance with Hong Kong Standard on Related Services 4400, "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures were performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution's application for voluntary revocation of authorization as a [deposit-taking company / restricted licence bank / bank]*. The procedures are summarized as follows:

1. We inspected the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [date].
2. We obtained from the management the balance sheet of the Institution as at [date] and agreed to the books and records of the Institution as at [date].
3. We obtained from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [date] and compared it to the books and records.
4. For the contingent liabilities and outstanding commitments, we also obtained and reviewed the minutes of the Board of Directors ("Board Minutes") for the period from [date] to [date].
5. We obtained a Representation Letter from the Board of Directors confirming the following:
 - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [date];
 - b. the balance sheet as at [date] agreed with the books and records of the Institution;
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [date].

We report our findings as follows:

- a. With respect to item 1, we found there were no third party customer deposit liabilities attached as at [date], and this was consistent with the information in the Representation Letter.
- b. With respect to item 2, we found the attached balance sheet as at [date] was in agreement with the books and records of the Institution as at [date], and was consistent with the information in the Representation Letter.
- c. With respect to item 3, we found the attached summary of contingent liabilities and outstanding commitments as at [date] was in agreement with the Institution's books and records, and was consistent with the information in the Representation Letter.
- d. With respect to item 4, we were not aware of any inconsistency of the information in the Board Minutes.

Because the above procedures do not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, we do not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments as at [date].

Had we performed additional procedures or had we performed an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report. It relates only to the items specified above and does not extend to any financial statements of the Institution, taken as a whole.

This report is intended for filing with the Monetary Authority. We have no objection that a copy of this report is given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
[Date]

** Delete where not appropriate*

APPENDIX 2

Examples of management representation letters

The following specimen letters are for reference only and will need to be modified according to the requirements and circumstances of individual AIs.

Example 1 – Management representation letter for reporting under section 63(3)

[Client's letterhead]

[Audit Firm]
[Address]

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3) of the Banking Ordinance to report on the following returns ("the Returns"):

- i) the [consolidated]* Return of Capital Adequacy Ratio of the [Bank / Company] as at [date]; [applicable to locally incorporated AIs only]
- ii) Parts I, II, and III, columns 1 - 5 of the [consolidated]* Return of Large Exposures of the [Bank / Company / Branch]* for the quarter ended [date];
- iii) Part I of the [consolidated]* Return of Liquidity Position of the [Bank / Company / Branch]* for the month of [month/year]; and
- iv) the [consolidated]* Certificate of Compliance of the [Bank / Company / Branch]* for the quarter ended [date].

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

The Returns

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting records and systems of control to ensure that the Returns have been correctly compiled from the books and records of the [Bank / Company / Branch]*, and that the [Bank / Company / Branch]* complies with the provisions of the Banking Ordinance at all times.
2. There have been no contraventions by the [Bank / Company / Branch]* of any of its duties under Part XII, XV, [XVII]* [applicable to locally incorporated AIs only] or XVIII of the Banking Ordinance during the period from [date] to [date] or which were the subject of correspondence during this period.
3. We are not aware of any matter which adversely affects the financial position of the [Bank / Company / Branch]* to a material extent.
4. [For registered institutions only] We are not aware of any matter that constitutes on the part of the [Bank / Company / Branch]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
5. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.
6. All the Returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the Monetary Authority.

Information Provided

7. All the Returns provided to you for the purpose of this engagement are the ones first submitted to the Monetary Authority.
8. All transactions undertaken by the [Bank / Company / Branch]* have been properly reflected and recorded in the accounting records.
9. All of the following information has been made available to you for the purposes of performing your procedures on the Returns:
 - i) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments (including derivative transactions and credit arrangements) of the [Bank / Company / Branch]*;
 - ii) All procedures manuals for the preparation of the Returns and compliance with the Banking Ordinance;
 - iii) Policies and procedures manuals for the key operating areas of the [Bank / Company / Branch]*;
 - iv) All instructions, correspondence and minutes or notes of meetings with the Monetary Authority;
 - v) Identities of all connected parties for the purpose of Part I of the Return of Large Exposures;
 - vi) Other information which may be relevant to the preparation of the Returns; and
 - vii) Unrestricted access to persons within the [Bank / Company / Branch]* from whom you determine it necessary to obtain audit evidence.
10. We have disclosed to you all communications between the [Bank / Company / Branch]* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the information presented in the Returns.
11. We have communicated to you all deficiencies in internal control of which we are aware of that could have a material effect on the information presented in the returns.

Yours faithfully

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

Director*/Chief Executive*

Chief Accountant

* *Delete where not appropriate*

Example 2 – Management representation letter for reporting under section 63(3A)

[Client's letterhead]

[Audit Firm]

[Address]

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3A) of the Banking Ordinance for the examination of our internal control systems to enable:

- i) the returns or information of the *[Bank / Company / Branch]** submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the *[Bank / Company / Branch]**;
- ii) the *[Bank / Company / Branch]** to comply with its duties under Parts XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* and XVIII of the Banking Ordinance; and
- iii) the *[Bank / Company / Branch]** to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur *[applicable to locally incorporated AIs only]*

for the period/year ended *[date]*.

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

Internal Control Systems

1. We have fulfilled our responsibilities for establishing and maintaining adequate internal control systems.
2. There were no changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses.
3. We are not aware of any violations or possible violations of the Companies Ordinance, the Banking Ordinance or any other regulations the effect of which should be considered for disclosure or as a basis for a provision.
4. There have been no contraventions by the *[Bank / Company / Branch]** of any of its duties under Part XII, XV, *[XVII]** *[applicable to locally incorporated AIs only]* or XVIII of the Banking Ordinance during the period from *[date]* to *[date]*. In particular, we confirm that the *[Bank / Company / Branch]** complied with sections [80, 81, 83, 85, 87, 87A, 88, 90, 98, 102 and 106] * *[applicable to locally incorporated AIs only]* [80, 85 and 102] of the Banking Ordinance as stated in the Certificates of Compliance submitted to the Hong Kong Monetary Authority ("HKMA") for the review period.
5. The *[Bank / Company]** has maintained at all times during the review period adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur *[applicable to locally incorporated AIs only]*.

6. We are not aware of any matter which adversely affects the financial position of the [*Bank / Company / Branch*]* to a material extent.
7. [*For registered institutions only*] We are not aware of any matter that constitutes on the part of the [*Bank / Company / Branch*]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.
8. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

Information Provided

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

Yours faithfully

[*For and on behalf of*]

Director*/Chief Executive*

Chief Accountant

* *Delete where not applicable*

**Example 3 – Management representation letter for report of factual findings
in relation to voluntary revocation of authorization**

[Client's letterhead]

[Audit Firm]

[Address]

[Date of report]

Dear Sirs

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

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

Financial Statements

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting records and systems of control to ensure that the financial statements of the *[Bank / Company / Branch]** for the period from *[date]* to *[date]* have been properly prepared from the books and records of the *[Bank / Company / Branch]**.
2. We confirm the following:
 - (a) As at *[date]*, the third party deposit liabilities of the *[Bank / Company / Branch]** are accurate and complete;
 - (b) As at *[date]*, the *[Bank / Company / Branch]** 's balance sheet agrees with the books and records made available to you. The *[Bank / Company / Branch]** has maintained adequate provision for its liabilities and commitments as at *[date]*; and
 - (c) As at *[date]*, there are no other outstanding commitments or contingent liabilities which have not been wound down or properly honoured or transferred by mutually satisfactory arrangements except for those stated in the summary of contingent liabilities and outstanding commitments as at *[date]* and disclosed in the attachment to your report. The summary of contingent liabilities and outstanding commitments are accurate and complete.

Information Provided

3. All transactions undertaken by the *[Bank / Company / Branch]** have been properly reflected and recorded in the accounting records.
4. All of the following information has been made available to you for the purposes of performing your procedures:
 - (a) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments of the *[Bank / Company / Branch]**;
 - (b) All relevant instructions, correspondence and minutes or notes of meetings with the Monetary Authority and our solicitors; and
 - (c) Other information which may be relevant to your agreed-upon procedures.

Yours faithfully

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

Director*/Chief Executive*

* *Delete where not applicable*

APPENDIX 3

Examples of engagement letters

The following example letters highlight only the aspects relating to the scope and responsibilities of the auditor for the purpose of reporting under the Banking Ordinance. These examples are for reference only and require the inclusion of other relevant terms of the engagement which will vary according to the requirements and circumstances of the individual auditor and client. The auditor may consider it appropriate to include a limitation of liability clause in the engagement letter in accordance with the auditor's risk management policies.

Example 1 – Engagement letter for reporting under section 63(3) and (3A) for locally incorporated AIs

The Board of Directors
XYZ Bank
[address]

[Date]

Dear Sirs

Objective of services

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

Responsibilities of the directors

- 2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.

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

It is the directors' responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

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

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

- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
- ii) the Institution to comply with its duties under Parts XII, XV, XVII and XVIII of the Ordinance;
- iii) the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

- 2.4 The directors are responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

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

- i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the Monetary Authority, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
- ii) In addition, our duty as auditor is to report whether or not, during the period:
- a) we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVII or XVIII of the Ordinance;
 - b) we are aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

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

Scope of work

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

("SPM IC-3") issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.

- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.
- iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 and with reference to Practice Note 830 issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.
- ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

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

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services).

[Set out other terms of the engagements as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ Bank

**Example 2 – Engagement letter for reporting under section 63(3) and (3A)
for local branch(es) of overseas incorporated AIs**

The Chief Executive
XYZ Bank – Hong Kong Branch
[Branch address]

[Date]

Dear Sirs

Objective of services

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

Responsibilities of management

- 2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.
- 2.2 Reporting under Section 63(3) of the Ordinance
- It is management's responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.
- 2.3 Reporting under section 63(3A) of the Ordinance
- It is management's responsibility to establish and maintain adequate internal control systems to enable:
- i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;
 - ii) the Institution to comply with its duties under Parts XII, XV and XVIII of the Ordinance.
- 2.4 The Institution's management is responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

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

- i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the HKMA, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.
- ii) In addition, our duty as auditor is to report whether or not, during the period, we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIII of the Ordinance.

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

Scope of work

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

4.2 Reporting under Section 63(3) of the Ordinance

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and with reference to Practice Note 830 “Reports by the Auditor Under the Banking Ordinance” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”). The procedures that we will perform to enable us to form our opinion will also be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 “Reporting Requirements Relating to Authorized Institutions’ External Auditors under the Banking Ordinance” (“SPM IC-3”) issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.
- ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution’s books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.

- iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority within a further month.

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

- i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 and with reference to Practice Note 830 issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.
- ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

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

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution and XYZ Bank rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services, or information provided to the head office of XYZ Bank and/or its other branches).

[Set out other terms of the engagements as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Chief Executive of XYZ Bank – Hong Kong Branch

**Example 3 – Engagement letter for report of factual findings
in relation to voluntary revocation of authorization**

The Board of Directors
XYZ
[address]

[Date]

Dear Sirs

Objective of services

- 1.1 You have requested that we prepare a report in relation to an application for voluntary revocation of authorization as a [deposit-taking company/restricted licence bank/bank]* by XYZ (the “Institution”). The scope and period to be covered in this engagement are set out in your Letter of Instruction dated [date]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our reporting the factual findings.

Scope of work

- 2.1 Our engagement will be conducted in accordance with Hong Kong Standard on Related Services 4400, “Engagements to Perform Agreed-upon Procedures Regarding Financial Information” issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and we will indicate so in our report.
- 2.2 We have agreed to perform the following procedures and report to you the factual findings resulting from our work:
- i) Inspect the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [date].
 - ii) Obtain from the management the balance sheet of the Institution as at [date] and agree to the books and records of the Institution as at [date].
 - iii) Obtain from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [date] and compare it to the books and records.
 - iv) For the contingent liabilities and outstanding commitments, obtain and review the minutes of the Board of Directors for the period from [date] to [date].
 - v) With respect to (i) – (iii) above, we will also obtain a Representation Letter from the Board of Directors confirming the following:
 - a. the accuracy and completeness of third party deposit liabilities of the Institution as at [date];
 - b. the balance sheet as at [date] agreed with the books and records of the Institution;
 - c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [date].
- 2.3 The procedures are performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution’s application for voluntary revocation of the authorization as a [deposit-taking company/restricted licence bank/bank]*. Our report is intended for filing with the Monetary Authority. We have no objection that a copy of our report will be given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, our report should not be distributed to any other party or used by anyone else or for

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

- 2.4 The procedures that we will perform will not constitute an assurance engagement in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA and, consequently, we will not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments.

[Set out other terms of the engagement as appropriate]

Agreement of terms

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

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

Director, for and on behalf of the Board of XYZ

**Delete where not appropriate*

APPENDIX 4

Guidance on ad hoc reports under section 61

The following guidance been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61 of the Banking Ordinance. Section 61 of the Banking Ordinance does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

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

The auditor

1. Section 61 provides that no duty to which an auditor of an AI shall be subject will be contravened "by reason of his communicating in good faith to the Monetary Authority, whether or not in response to a request made by the Monetary Authority, any information or opinion on a matter to which he becomes aware in his capacity as auditor and which is relevant to any function of the Monetary Authority under this Ordinance". It is this section which makes it clear that the auditor is able to communicate with the HKMA by way of a formal report, at a meeting or by any other means on any matters relating to the AI's affairs arising out of the appointment and which are relevant to any function of the HKMA under the Ordinance. These matters include those which are relevant to the reports made by the auditor, to any discussions with the HKMA and to those exceptional circumstances which are referred to in paragraphs 13 and 14 of this Appendix. The HKMA believes that the auditor may communicate a matter to the HKMA with the protection of section 61 regardless of the source of that information, provided the auditor becomes aware of the matter in the capacity as the auditor of that client AI.
2. Confidentiality is generally either an implied or explicit term of the auditor's contracts with the clients, but in section 61 circumstances it does not prevail since they are entitled to communicate information or opinions relating to the business or affairs of the AI without contravening the duty of confidence owed to the AI.
3. References in the following paragraphs of this guidance to "reporting under section 61" refer to reporting with the protection of section 61.
4. It is important to stress that the HKMA expects that the management of the AI will continue to be its primary source of information and that the normal reporting procedures, including the reports on statutory returns, the prudential meetings and any tripartite meetings will normally provide the HKMA with most of the information it needs to carry out its responsibilities under the Ordinance.
5. The auditor cannot, however, be expected to be aware of all circumstances which, had the auditor known of them, would have led the auditor to exercise the right to report under section 61. That section does not require the auditor to change the scope of the audit work, nor the frequency or timing of the audit visits. The auditor does not have an obligation to seek out grounds for making a report under section 61; the section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover an occurrence of the kind described in paragraph 10 of this Appendix. It is only when the auditor becomes aware in the ordinary course of the audit work of such an occurrence that the auditor would make detailed enquiries with section 61 specifically in mind.
6. The HKMA recognizes that it would not be appropriate for the auditor to report to it, information which the auditor has obtained through the professional relationship with another client which is not the AI, even though the information obtained or the matters identified may relate to the AI.

7. The auditor would realize that there are circumstances in which section 61 will not provide protection, for example, where the auditor could be held to have acted maliciously or in bad faith. The Ordinance does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by the auditor's action in reporting to the HKMA. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of the report are such as to secure the protection of section 61 and that it only includes relevant material. However, the auditor would recognize that speed of reporting may well be important in order to protect the interests of depositors. There is no protection given by the Ordinance if the auditor fails to report to the HKMA.

The HKMA

8. Information which is confidential and has been obtained by the HKMA under, or for the purposes of, the Ordinance can only be disclosed in given circumstances. However, under section 120(5)(g), the HKMA is not precluded from disclosing information "to an auditor of an authorized institution or former authorized institution or to a former auditor for the purpose of enabling or assisting the Monetary Authority to discharge his functions under this Ordinance". It should be noted that disclosure by the HKMA of confidential information to the auditor is to the auditor only; the auditor is not free to pass that information to others, such as the client AI without the HKMA's consent.
9. The HKMA has confirmed that it will take the initiative, usually by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditor:
 - a. when it believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of the audit or other report or the way in which the auditor carries out the reporting responsibilities; and
 - b. when the disclosure is for the purpose of enabling or assisting the HKMA to discharge its functions under the Ordinance or will otherwise be in the interests of depositors.

The HKMA will indicate whether management of the AI has been informed of the matter and if so, who has been advised. If the auditor is not informed by the HKMA of any such matter, the auditor is entitled to assume that the HKMA has no such disclosure to make. Accordingly, there is no need for the auditor to request the HKMA to confirm this.

Taking the initiative

10. The HKICPA has developed a criterion for use by the auditor in deciding whether to take the initiative in making an ad hoc report in addition to the regular reporting responsibilities. The criterion is that the auditor would take the initiative when the auditor considers it expedient to do so in order to protect the interests of depositors because there has been a material loss or there exists a significant risk of material loss. This criterion can be more fully explained as follows:
 - a. there must be an adverse occurrence, or a change in the auditor's perception of an existing situation, which may include an adverse change in the circumstances of the AI; and
 - b. the position described in a. above has given rise to a material loss or indicates that a reasonable probability exists that a material loss may arise; and
 - c. the position is such that the interests of depositors might be better safeguarded if the HKMA were aware of it.
11. As stated in paragraph 5 of this Appendix, the auditor is not required to seek out grounds for making a report. It is only where the auditor becomes aware during the ordinary course of the work that the criterion might be satisfied that the auditor would take the matter further.

Reporting via the AI

12. It is important for the auditor to act in a manner that will preserve the professional relationship with the client. Normally, therefore, the auditor would ask the AI to draw matters about which the auditor is concerned to the attention of the HKMA. Examples of circumstances encountered in which the criterion set out in paragraph 10 of this Appendix may be met and the matter reported via the AI are:
- a. when there appears to the auditor to be a material contravention of one or more of the requirements of the Ordinance;
 - b. where it has come to the attention of the auditor that there is an extreme situation, such as evidence of imminent financial collapse, where it is obvious that the HKMA must be informed;
 - c. where the auditor has evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's net assets;
 - d. when the auditor forms the opinion that there has been a significant failure of, or that there is a significant weakness in, the accounting and other records or the internal control systems;
 - e. when the auditor forms the opinion that management has reported financial information to the HKMA which is misleading in a material particular (or become aware that management has failed or does not intend to report something and the failure to report is, or would be, materially misleading).

Reporting direct to the HKMA

13. In exceptional circumstances, where it is in the interests of protecting depositors that the management of the AI should not be informed in advance, the auditor would report direct to the HKMA after first considering the appropriateness of taking independent legal advice. Examples of these circumstances are:
- a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where the auditor believes that a fraud or other misappropriation has been committed by the directors or senior management of the AI, or they have evidence of the intention of directors or senior management to commit such fraud or misappropriation;
 - b. where there has been an occurrence which causes the auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g. where the auditor has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the AI's affairs, or they have evidence of an intention so to act.
14. Additionally, as outlined in paragraph 16.b. of this Appendix, a direct report would be made where the AI will not itself inform the HKMA of a matter, having been advised to do so by the auditor or where it has not done so within the period of time specified, or where there is not adequate evidence that the AI has properly reported the matter in question.

Reporting procedures

15. In forming a view as to whether it is expedient to report a matter to the HKMA, the auditor would follow the procedures in making enquiries and obtaining and assessing relevant evidence which are a normal part of forming a professional judgment in relation to an audit or investigation.

16. Where the auditor becomes aware of a matter which in the professional judgment the auditor considers ought to be reported to the HKMA, the auditor would consider adopting the following procedures, bearing in mind that speed may be of the essence:
- a. The auditor would consider the facts and unless inappropriate in the circumstances, discuss the matter with the management of the AI.
 - b. In normal circumstances, the auditor would establish whether the matter has already been reported by the AI through the usual channels, and if so, obtain from the AI a copy of the HKMA's written acknowledgement sufficient to establish that the matter has been properly reported.
If the matter has not already been reported by management, the auditor would write to the AI setting out the views and requesting the directors or management to inform the HKMA of the matter, within a specified period of time. The auditor would then obtain from the AI evidence of prompt acknowledgement from the HKMA sufficient to establish that the matter has been properly reported.
In the absence of such evidence, it may be appropriate for the auditor to report the matter direct to the HKMA, and to inform the management of the AI of the contents of the report.
If the directors or management have not informed the HKMA and continue to refuse to inform it within the specified period of time, the auditor would report direct to the HKMA.
 - c. If the situation is sensitive, for example in the circumstances outlined in paragraphs 13.a. and b. of this Appendix, it may be inappropriate to discuss the matter with the normal levels of management. The auditor would, therefore, consider reporting to the appropriate senior level within the AI with a view to the HKMA being informed of the situation by a senior representative of the AI. The auditor would then obtain evidence from the AI of prompt acknowledgement by the HKMA sufficient to establish that the matter has been properly reported. In the absence of such evidence, it will then be appropriate for the auditor to report direct to the HKMA.

In exceptional circumstances where the auditor feels that in the interests of speed and/or, because of the nature of the matter, it is not appropriate or practical to inform or discuss the matter with anyone connected with the AI, the auditor would make an appropriate written or other report direct to the HKMA after considering the appropriateness of taking independent legal advice.

17. The auditor would have to satisfy themselves that the decision will stand up to examination at a future date on the basis of the following considerations:
- what the auditor knew at the time;
 - what the auditor should have known in the course of the audit or investigatory work;
 - what the auditor should have concluded; and
 - what the auditor should have done.
18. Speed of reporting will often be important to the protection of the interests of depositors. A report would be made as soon as the auditor reasonably can after forming the view that it is expedient to do so in order to protect the interests of depositors. For the auditor this may well mean ensuring that an ad hoc report is made to the HKMA in advance of making the report after considering the appropriateness of taking independent legal advice.
19. The auditor would note that in the situations outlined in paragraphs 13 and 14 of this Appendix, making an ad hoc report alone may not discharge all the auditor's responsibilities. An example of this would be the auditor considering the implications of the ad hoc report for the auditor's opinion on the financial statements.

20. To ensure that the HKMA is informed promptly of matters which meet the criterion, a firm acting as the auditor or reporting accountant would ensure:
- a. that all staff responsible for banking and deposit-taking assignments are aware of the provisions of the appropriate legislation and the contents of this guidance, and are able to identify situations in which section 61 might operate; and
 - b. that satisfactory procedures exist to ensure that any information, which may be the subject of an ad hoc report, obtained by staff in the course of the work, is passed on to the partner responsible without unnecessary delay.

APPENDIX 5

The Banking Ordinance – Important provisions for the auditor

This list is based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

Section

Powers of control over AIs

- 52 The Monetary Authority (MA) has powers to require an AI to take any action the MA deems necessary, to appoint a person to advise on the proper conduct of business, to assume control of the AI, to report matters to the Chief Executive in Council.

Power to examine and investigate AIs

- 55 The MA can examine books and records of an AI and group companies.

Audited financial statements

- 59 An AI and its auditor are required to comply with the Companies Ordinance with respect to the audit of the AI's financial statements; the MA has the power to appoint another auditor.
- 60 Requirement for an AI incorporated in Hong Kong to exhibit its audited financial statements in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch not later than 4 months after the end of the financial year.

Reports on statutory returns used for prudential purposes

- 50(1)(c) The MA can require an auditor's report on returns or information on an overseas branch of an AI incorporated in Hong Kong.
- 63(3) The MA can require an auditor's report on returns or other information submitted to the MA under this section.

Reports on internal control systems

- 59(2) The MA can request ad hoc reports by the auditor on certain internal control systems.
- 63(3A) The MA can request recurring annual reports by the auditor on certain internal control systems and other matters.

Notification in respect of the auditor

- 59A(1) Requirement for an AI incorporated in Hong Kong to notify the MA with respect to proposed or actual changes of the auditor.
- 59A(2) Requirement for an auditor of an AI appointed under section ~~395, 396, 397 or 398~~⁴³⁴ of the Companies Ordinance to notify the MA if he resigns, decides not to seek reappointment or decides to qualify the financial statements.
- 63A Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter which, in his opinion, adversely affects the financial position of an AI to a material extent.

- 63B Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter that, in his opinion, is a matter that constitutes on the part of the institution a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section).

Communication by the auditor with the MA

- 61 Ability of the auditor to communicate to the MA certain information or opinion notwithstanding duties to clients (whether an AI or a former AI).

Investigations

- 117 Power of the Financial Secretary to appoint competent persons to investigate an AI and a former AI.
- 118 Duty of the auditor to provide information etc. to competent persons.

APPENDIX 6

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

This summary is based on the Securities and Futures Ordinance and its subsidiary legislation which were effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the law for the precise requirements.

Section 157 of the Securities and Futures Ordinance (SFO)

Under section 157(3) of the SFO, “prescribed requirement” means such of the requirements under any of the rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO for the purposes of this definition.

Section 5 of the Securities and Futures (Accounts and Audit) Rules made under section 397(1) of the SFO

The following provisions are prescribed requirements for the purposes of the definition of “prescribed requirement” in section 157(3) of the SFO:

- (a) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
- (b) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
- (c) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules.

The Securities and Futures (Client Money) Rules are rules made under section 149 of the SFO. According to section 63B of the Banking Ordinance, the requirements under section 149 of the SFO or of rules made under that section are excluded.

Securities and Futures (Keeping of Records) Rules

This is a set of subsidiary legislation made under section 151 of the SFO which specifies the records that intermediaries and their associated entities are required to keep, the manner in which they are required to be kept and other matters relating to the keeping of the records.

Relevant sections

- Section 3 General record keeping requirements for intermediaries
- Section 4 Record keeping requirements for associated entities

Securities and Futures (Client Securities) Rules

This is a set of subsidiary legislation made under section 148 of the SFO which prescribes the manner in which intermediaries and their associated entities shall treat and deal with client securities and securities collateral received or held in Hong Kong.

Relevant sections

- Section 4 Requirements in respect of a client’s standing authority
- Section 5 Requirement for deposit or registration of client securities and securities collateral
- Section 10 Limitations on treatment of client securities and securities collateral
- Section 12 Reporting of non-compliance with certain provisions of the Rules

APPENDIX 7

Checklist for the auditor

This checklist has been prepared for the guidance of the auditor who is required to report on compliance with Parts XII, XV, XVII and XVIII of the Banking Ordinance based on the Banking Ordinance which was effective as at 31 October 2004. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

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

Answer the following questions for the period to be covered by the report only:

**Section
Ref.**

Part XII Disclosure of Information

1. **Returns and information required by the HKMA**
 - a. Returns and information

63(1) Did the AI submit the required monthly and quarterly returns and such other information to the HKMA within the required 14 days or such period as the HKMA may require?
 - b. Matters which adversely affect the financial position of the AI to a material extent

63A Are you aware of any matter that may adversely affect the financial position of the AI to a material extent? If so, a report in writing on the nature of the matter and the reason supporting this opinion are required to be submitted to the HKMA.
 - c. Failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance

63B Are you aware of any matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section)? If so, a report in writing on the matter is required to be submitted to the HKMA as soon as reasonably practicable.
 - d. Shareholding

64(1)&(2) Has the AI informed the HKMA of the name, address, nature of business and other information required about companies:

 - i. in which the AI beneficially holds 20% or more of the share capital;
 - ii. where any director or manager of that company is also a director, chief executive or manager of the AI;
 - iii. where the name of that company has common features with the name of the AI;
 - iv. which, by whatever means, acts in concert with the AI to promote the AI's business; or
 - v. the controller of which is also the controller of the AI.

- e. Changes to constitution
- 65 Are there changes to the constitution of the AI of which the HKMA has not yet been notified within the required 30 days?
- f. Cessation of business
- 66 Has the AI ceased to carry on banking/deposit-taking business and if so, has it notified the HKMA in writing?
- g. Inability to meet obligations
- 67(1) Is the AI likely to become unable to meet its obligations or is it about to suspend payment? If so, has it notified the HKMA?
- 2. Maintenance of adequate provision for depreciation and diminution in value of assets**
- 63(3A) Has the AI at all times during the period under examination had in place systems of control which are adequate to enable it to maintain adequate provision:
- a. for depreciation;
 - b. against the diminution, if any, in the value of its assets, including provision for bad and doubtful debts;
 - c. for liabilities which will or may fall to be discharged by it; and
 - d. for losses which will or may occur?

Part XV Limitation on Loans by and Interests of AIs

- 3. Advance against security of own shares**
- 80 Has the AI complied with the requirement not to grant any advances, loans or credit facilities (including letters of credit) or give any financial guarantee or incur any other liability:
- a. against the security of its own shares; and
 - b. against the security of the shares of
- 80(2)
- i. any holding company of the AI;
 - ii. any subsidiary of the AI; or
 - iii. any other subsidiary of any holding company of the AI,
- except with the approval in writing of the HKMA?
- 4. Limitation on advances**
- 81(1)
- a. Has the AI instituted an adequate and effective management control to ensure that its financial exposure to:
 - i. any one person;
 - ii. any two or more companies which have the same holding company;

- iii. any two or more companies which have the same controller;
- iv. any holding company and one or more of its subsidiaries;
- v. any one person and one or more companies of which that person is a controller,

does not exceed 25% of its capital base?

Notes:

- 81(2) [1] *Financial exposure for this purpose means the aggregate of:*
- [a] *all advances, loans and credit facilities (including letters of credit) by the AI;*
 - [b] *the value of the AI's holdings of shares and debentures and other debt securities issued by that company, person or combination thereof;*
 - [c] *financial exposures (declared in a notice to be financial exposure) of the AI to that company, person or combination thereof; and*
 - [d] *the principal amount, multiplied by a factor specified by the HKMA and published in the gazette - for items referred to in Table B of the Third Schedule to the Ordinance.*
- 81(6) [2] *Financial exposure does not include:*
- *exposure to other AIs;*
 - *exposure to an overseas incorporated bank which is not an AI where it is, in the opinion of the HKMA, adequately supervised by the relevant banking supervisory authority;*
 - *exposure to the extent to which it is secured by a cash deposit, a guarantee, an undertaking which is similar to a guarantee, or securities issued, or guaranteed, by the central government or the central bank of any Tier 1 country within the meaning of the Third Schedule to the Banking Ordinance and such collateral or guarantee is accepted by the HKMA. The general criteria that the HKMA will apply in assessing whether such collateral or guarantee is acceptable are set out in the HKMA's Supervisory Policy Manual CR-L-2 "Exemption of Financial Exposures: §81(6)(b)(i)";*
 - *exposure to the extent to which it is covered by a letter of comfort accepted by the HKMA. See CR-L-3 "Letters of Comfort: §81(6)(b)(ii)" for the criteria that the HKMA will apply in assessing whether such letters of comfort are acceptable;*
 - *exposure acquired by the purchase of bills of exchange or documents of title to goods where the holder of such bills or documents is entitled to payment outside Hong Kong for goods exported from Hong Kong;*
 - *advances, loans and credit facilities made against the bills or documents mentioned above;*
 - *exposure to the Hong Kong Special Administrative Region Government or any other government acceptable to the HKMA;*
 - *share capital or debt securities held as collateral for facilities granted or acquired by the AI during debt recovery. In the latter case, the AI is, however, required to dispose of such collateral at the earliest possible opportunity, and in any case within 18 months after the acquisition or within such further period as may be approved by the HKMA;*
 - *an indemnity issued by the AI to a person to protect that person from any damages which may be incurred as a result of the person registering a transfer of shares (e.g. lost share certificates), provided that certain specified conditions are met;*

- *exposure acquired under an underwriting or sub-underwriting contract. If the exposure is an on balance sheet item, the exemption will only last for a period not exceeding seven working days or such further period as may be approved by the HKMA (see the HKMA's Supervisory Policy Manual CR-L-4 "Underwriting of Securities: §§81 and 87" for the HKMA's policy on extending the exemption period for the underwriting or sub-underwriting of securities);*
 - *exposure to a multilateral development bank as defined in the Third Schedule to the Banking Ordinance;*
 - *exposure to the Housing Authority arising from guarantees given to AIs under the Home Ownership or Private Sector Participation Scheme;*
 - *exposure to The Hong Kong Mortgage Corporation Limited (HKMC) arising from its obligations under the Mortgage Insurance Programme;*
 - *exposure to the extent that it has been written off or specifically provided for in the books of the AI; and*
 - *exposure to the HKMC or any company that issues mortgage-backed securities in connection with the HKMC's Guaranteed Mortgage-Backed Pass-Through Securitisation Programme, if the exposure to the HKMC or the company arises from the obligations placed upon it for the purposes of the Programme.*
- b. Are you aware of any financial exposure of the AI during the period under review which was in contravention of this limitation?
- 81(6) c. In respect of transactions covered by a "letter of comfort", is the aggregate amount of the financial exposure within the limitation imposed by:
- the HKMA; or
 - the terms of the letter of comfort?

Notes:

- [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

5. Compliance with guidelines on business practices

- 82(1) Has the AI complied with the requirement not to engage in those business practices specified in the guidelines, if any, published by the HKMA, after consultation with the Financial Secretary by notice in the Gazette?

Notes:

- [1] *The HKMA has the discretion to prohibit those business practices, which it considers will or may cause the soundness of the financial position of AIs to be dependent upon the soundness of the financial position of a single party.*
- 82(2) [2] *Such guidelines may apply to all AIs or to a class of AIs as specified in the notice.*
- [3] *Such guidelines may specify what constitutes a single party and, without prejudice to the generality of that power, any class or description of persons or business may constitute such a single party.*

6. Limitation on advances to directors etc.

- 83 a. Has the AI instituted an adequate and effective management control to ensure that it does not grant, or permit to be outstanding, any unsecured* advances, loans, credit facilities, financial guarantees or incur any other unsecured* liability to:
- 79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.
- 83(4) i. any director of the AI;
- ii. any relative of such director;
- iii. any employees responsible, either individually or as a member of a committee, for approving loan applications;
- iv. any relative of any such employee;
- v. any controller of the AI;
- vi. any relative of an individual who is a controller of the AI;
- vii. any firm, partnership or non-listed company in which the AI or any of its controllers or its directors (or relative of its controllers or directors) is interested as director, partner, manager or agent; and
- viii. any individual, firm, partnership or non-listed company of which any of the AI’s controllers or directors (or relative of its controllers or directors) is a guarantor,
- 83(1) to an aggregate amount in excess of
- aa. 10% of the capital base of the AI; or
- 83(2) bb. 5% of the capital base of the AI in respect of one or more persons included in i. to vi. above; or
- cc. \$1,000,000 in respect of any one person included in i. to vi. above.
- b. Are you aware of any loans or advances etc. granted or outstanding during the period under examination which were in contravention of any of these limitations?

Notes:

- 83(5) [1] *The above shall apply to a facility granted jointly with another party as they apply to a facility granted severally.*
- 83(1) [2] *The above section does not apply to AIs incorporated outside Hong Kong.*
- 79A [3] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

7. Limitation on advances to employees

- 85 Has the AI complied with the requirement not to grant, or permit to be outstanding, unsecured* advances, loans, credit facilities to, and not to give unsecured* financial guarantees or incur any other unsecured* liability in respect of, any one of its employees to an aggregate in excess of one year’s salary for any such employee?

79(3) * Unsecured is defined as being granted without “such security as would, in the opinion of the HKMA, be acceptable to a prudent banker”. In this connection it is considered that an unsupported personal guarantee does not constitute security.

8. Moneys placed with foreign banks

86 Is there any notice from the HKMA prohibiting the AI from granting any advances, loans, deposits or credit facilities to or directing the AI to demand repayment from any foreign banks?

Note:

86(4) “Foreign bank” means:

[1] any bank incorporated outside Hong Kong which is not licensed under the Banking Ordinance;

[2] any undertaking of an AI which is situated outside Hong Kong.

9. Limitation on shareholding

87(1) Has the AI complied with the requirement not to acquire or hold any share capital of another company or companies of an aggregate value which exceeds 25% of the capital base of the AI except that:

- a. such share capital is held as security for facilities granted by the AI; or
- b. such share capital is acquired in the course of satisfaction of debts due to the AI. In any event, such acquisitions must be disposed of within 18 months unless the HKMA has agreed to an extension of time.

- 87(2) c. by virtue of specified underwriting contracts; or
- d. in respect of shareholdings, approved in writing by the HKMA, in another AI or in a company carrying out nominee, executor or trustee functions or other functions related to banking/deposit-taking business or other financial services;
- e. in respect of any holding, approved by the HKMA, of share capital which is deducted in determining the capital base of the AI?

87A Has the AI complied with the requirement not to acquire all or part of the share capital of a company to a value of 5% or more of the capital base of the AI at the time of the acquisition except with the approval of the HKMA?

Notes:

87(1) [1] This section does not apply to AIs incorporated outside Hong Kong.

79A [2] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

10. Limitation on holding of interest in land

88(1) Has the AI complied with the requirement not to purchase or hold any interest in land situated in or outside Hong Kong of an aggregate value which exceeds 25% of its capital bases excluding:

- 88(2)/(3) a. land necessary for occupation for its business purposes or for staff housing; and
- 88(5) b. the value of land mortgaged to the AI by way of security for debts due to the AI, or the value of any interest acquired pursuant to entry into possession of land so mortgaged, provided that such mortgaged land must be disposed of within 18 months unless the HKMA has agreed to an extension?

Notes:

- 88(1) [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

11. Limitation on aggregate holdings

- 90(1) Has the AI complied with the requirement not to permit its aggregate holdings of:
- a. amounts outstanding of all facilities granted to specified bodies (as defined in section 83(3)&(4));
- b. shareholdings in other companies (as defined in section 87); and
- c. interests in land (as defined in section 88(1)&(2)),
- to exceed 80% of the capital base of the AI?

Notes:

- [1] *This section does not apply to AIs incorporated outside Hong Kong.*
- 79A [2] *The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.*

Part XVII Capital Adequacy Ratio

12. Capital adequacy ratio

- 98(1) Has the AI maintained at all times during the period under review a capital adequacy
101(1) ratio of more than the percentage stipulated by the HKMA as calculated in accordance with the provisions of the Third Schedule?

Notes:

- 100(1)&(2) [1] *If the AI contravenes section 98(1) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.*
- 3rd Sch. [2] *The capital adequacy ratio shall be calculated as the ratio, expressed as a percentage, of its capital base to its risk weighted exposure as specified in the Third Schedule.*
- 98(2) [3] *If the AI has a subsidiary, the HKMA may, by notice in writing, require the
98(2A) capital adequacy ratio to be calculated on a consolidated basis, or both consolidated and unconsolidated basis. The notice may specify those subsidiaries to be included.*
- 98(3) [4] *The minimum percentage requirement may be varied by the Financial Secretary by notice in the Gazette.*

101(1) [5] *The percentage requirement of 8% may also be increased by the HKMA to not more than 12% for a particular bank, or 16% for a particular restricted licensed bank or deposit-taking company.*

98(1) [6] *The requirement does not apply to AIs incorporated outside Hong Kong.*

Part XVIII Liquidity Ratio and Matters Affecting Liquidity Ratio

13. Liquidity ratio

102(1) Has the AI maintained in the period under review a liquidity ratio of not less than 25% as calculated in accordance with the provisions of the Fourth Schedule and Part XVIII?

Notes:

4th Sch. [1] *The liquidity ratio shall be calculated as the ratio, expressed as a percentage, between its liquefiable assets and its qualifying liabilities, as specified in the Fourth Schedule to the Ordinance.*

102(3) [2] *Assets and liabilities of branches outside Hong Kong shall not be taken into account in the computation of the liquidity ratio.*

102(4) [3] *The minimum percentage limit may be varied by the Financial Secretary by notice in the Gazette.*

105(1) [4] *The percentage limit for a particular AI may also be varied by the HKMA.*

14. Charges over assets

106(1) Has the AI complied with the requirement that the sum total of all amounts secured by way of charge over its assets (excluding contra items) is less than 5% of the sum total of the value of those assets unless the HKMA has approved a higher amount?

Notes:

[1] *This section does not apply to AIs incorporated outside Hong Kong.*

106(2) [2] *The MA may, by notice in the Gazette, specify a charge, or a class of charges, to which the above section shall not apply.*

15. Civil proceedings

106(3) Has the AI any civil proceedings instituted against it which materially affect, or could materially affect, the financial position of the AI and which have not been notified to the HKMA?

Note:

This section does not apply to AIs incorporated outside Hong Kong.

30 October 2014
Exposure Draft

Response Due Date
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ED of PN 860.1 (Revised)

The Audit of Retirement Schemes



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

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ED of PN 860.1 (Revised) *The Audit of Retirement Schemes*

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/>.



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The Audit of Retirement Schemes



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

**PRACTICE NOTE
860.1 (REVISED)
THE AUDIT OF RETIREMENT SCHEMES**

*(Issued [] 2014 Effective for financial statements which cover a period beginning on or after
3 March 2014.
Early application is not permitted)*

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APPENDIX 2 – TEMPLATE OF FORM A UNDER SECTION 20(7A) OF THE ORSO

PRACTICE NOTE
860.1 (REVISED)
THE AUDIT OF RETIREMENT SCHEMES

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 retirement schemes, with particular focus on those registered under the Mandatory Provident Fund Schemes Ordinance (MPFSO) and the Occupational Retirement Schemes Ordinance (ORSO).
2. This Practice Note also provides guidance relevant to the auditor's other reporting responsibilities under the MPFSO and the ORSO:
 - a. the MPFSO
 - i. the auditor's report on compliance with prescribed capital adequacy requirements pursuant to sections 18 and 115 of the Mandatory Provident Fund Schemes (General) Regulation (General Regulation);
 - ii. the auditor's report on a review of the trustee's report on control objectives and internal control measures pursuant to section 113 of the General Regulation; and
 - iii. the report by the auditor of a service provider under section 74(5)(b) of the General Regulation.
 - b. the ORSO
 - i. the report by the auditor appointed by the administrator under section 20(1)(b) and 20(3) of the ORSO; and
 - ii. work of the employer's auditor under section 20(7A) of the ORSO.

Guidance is also provided on the communications between the auditor and the Mandatory Provident Fund Schemes Authority (MPFA).

3. This Practice Note has been prepared in consultation with the MPFA.
4. This Practice Note is based on the ORSO in effect as at 23 July 1999 (i.e. the ORSO as amended by the Occupational Retirement Schemes (Amendment) Ordinance 1999), and the MPFSO and the General Regulation in effect as at 25 April 2013, and guidelines issued by the MPFA up to November 2013. 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.

5. It should be borne in mind that certain expressions used in the MPFSO, the General Regulation and the ORSO 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

6. The definitions used in this Practice Note are:
- a. *Administrator*
The trustee of an ORSO scheme governed by trust or the insurer of an ORSO scheme which is regulated by an insurance arrangement.
 - b. *Aggregate past service liability*
As defined in section 2(1) of the ORSO.
 - c. *Aggregate vested liability*
As defined in section 2(1) of the ORSO.
 - d. *Authorized financial institution*
An institution authorized under Part IV of the Banking Ordinance.
 - e. *Authorized insurer*
An insurer authorized under section 8 of the Insurance Companies Ordinance.
 - f. *Control objectives*
In relation to a MPF scheme, the control objectives for the time being applicable to the scheme maintained under section 39 of the General Regulation.
 - g. *A defined benefit scheme* is one which is not a defined contribution scheme.
 - h. *A defined contribution scheme* is one which provides that amount of a benefit under the scheme is to be an amount determined solely by reference to:
 - i. the contributions to the scheme's funds by or in respect of the member concerned and any declared return in respect of such contributions (where such return may be subject to a minimum guaranteed rate but is otherwise unascertainable before it is declared); and
 - ii. where appropriate, the qualifying service and age of the member (employee).
 - i. *Encumbrance* includes a charge, pledge, lien and mortgage.
 - j. *MPFSO*
Mandatory Provident Fund Schemes Ordinance.
 - k. *General Regulation*
Mandatory Provident Fund Schemes (General) Regulation.
 - l. *Exemption Regulation*
Mandatory Provident Fund Schemes (Exemption) Regulation

- m. *MPF Code*
Code on MPF Investment Funds
- n. *MPFA*
Mandatory Provident Fund Schemes Authority.
- o. *MPF scheme*
A retirement scheme registered under section 21 of the MPFSO as an employer sponsored scheme or a master trust scheme, or section 21A of the MPFSO as an industry scheme.
- p. *ORSO*
Occupational Retirement Schemes Ordinance.
- q. *ORSO scheme*
A retirement scheme registered under the ORSO.
- r. *Pooling arrangement or agreement*
A pooling arrangement or agreement is one where two or more schemes are administered together. Under such an arrangement, a number of individual schemes can participate either through a master trust deed or a master insurance policy depending on whether the pooling arrangement is governed by a trust or is the subject of, or regulated by an insurance agreement. Master trust schemes and industry schemes established under the MPFSO also operate within a pooling arrangement.
- s. *Relevant employer*
An employer who provides the employment which entitles or enables the employee to be a member of a retirement scheme.
- t. *Relevant undertaking*
Relevant undertaking is defined by section 20(4) and Schedule 2 Parts 1 and 2 paragraph 6 of the ORSO as a written undertaking by the relevant employer of the scheme to the administrator of the scheme to contribute to the scheme's fund in accordance with recommendations made by the actuary in the actuarial certificate issued as regards a particular scheme. Where more than one actuarial certificate has been issued, the undertaking referred to is the one in the most recent of those certificates which is applicable to the financial period under review.
- u. *Retirement scheme/scheme*
Any instrument or agreement (other than contracts of life insurance) to provide a benefit, payable on termination of service, death, retirement or otherwise, to a person or his beneficiary as a result of a contract of service of employment, whether in Hong Kong or elsewhere. For the purpose of this Practice Note, this includes self-employed persons.
- v. *Rules*
MPFSO/ ORSO Subsidiary Legislation

w. *Trustee*

Approved trustee of MPF schemes.

Regulatory background

7. Retirement schemes are generally either constituted as trusts or insurance arrangements (policies). Retirement schemes in Hong Kong are required to be registered under the MPFSO or the ORSO, although schemes may apply to the MPFA for an exemption. The MPFA assumes the role as the Registrar of Occupational Retirement Schemes (Registrar) in administering the ORSO with effect from 10 January 2000. Exemption from the ORSO (section 7) is allowed for schemes with not more than 10% or 50 of their members, whichever is less, being Hong Kong permanent identity card holders. In exceptional cases, exemption may also be granted, at the discretion of the MPFA, for offshore schemes which are registered or approved by a recognised overseas authority.
8. The environment in which a retirement scheme operates is different from that of most commercial enterprises. The auditor would need to be familiar with the regulatory background to retirement schemes, in particular the requirements of the MPFSO, the General Regulation, the Exemption Regulation, the ORSO, the relevant Rules, guidelines and codes issued by the MPFA, as appropriate, and the accounting aspects of their operation before commencing the audit.
9. For schemes registered under the MPFSO or the ORSO, the trustee/administrator has various responsibilities imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA. The three main objectives of the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA are regulation, segregation and information.

Administration of a retirement scheme

10. The administration of a retirement scheme involves the input and interaction of a number of different parties:
 - a. the relevant employer - has an on-going responsibility for providing adequate funding to the scheme and ensuring that his obligations under the scheme terms and the relevant legislation are properly discharged;
 - b. the trustee/administrator - is responsible for ensuring that the scheme is administered in accordance with its governing rules/trust deed, and where applicable, the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA;
 - c. the employee (or the member) - has a responsibility for providing contributions to the scheme (in the case of a contributory scheme) and as the ultimate beneficiary of the scheme has a vested interest in ensuring that the scheme is administered properly and is providing appropriate returns on the contributions made;
 - d. the administrator's/trustee's auditor - is responsible for the independent audit of the scheme;
 - e. the employer's auditor - is responsible for examining the relevant records of the employer and preparing the employer's auditor's statement for ORSO schemes (see paragraphs 196 to 215 below); and
 - f. the scheme actuary - is responsible for reviewing the sufficiency of the scheme's assets and preparing the actuarial certificate for defined benefit schemes (see paragraphs 25 to 32 below).

11. While the trustee/administrator is ultimately responsible for the proper operation of a retirement scheme, he may choose to delegate some or all of his management functions to a third party. Where the trustee has delegated any function to a service provider (such as the administration or the investment function), the trustee/administrator must ensure that there are internal control procedures in place to monitor the activities of the service providers. The trustee/administrator must ensure that the service providers have carried out their duties in accordance with the agreements and the trustee/administrator is notified of any material changes relating to the eligibility of the service providers or material breach of obligations by the service providers.

Audit requirements

12. The audit requirements of MPF schemes and ORSO schemes are set out respectively in Parts II and III of this Practice Note below.
13. The auditor ensures that he/ she is familiar with Hong Kong Accounting Standard 26 "Accounting and Reporting by Retirement Benefit Plans" which deals with accounting and reporting by the plan to all participants as a group.

Commentary on the application of Hong Kong Standards on Auditing (HKSA)s

Compliance with HKSA)s

14. HKSA)s apply to the audits 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 is set out in paragraphs 15 to 44 below identifies the special considerations arising from the application of individual HKSA)s to the audits of the financial statements of retirement schemes. Where no special considerations arise from a particular HKSA, no material is included.

Engagement letters

15. The auditor issues engagement letters in accordance with the principles and requirements of HKSA 210 "Agreeing the Terms of Audit Engagements". Specific issues which the auditor would address in engagement letters applicable to retirement schemes include:
- a. the nature and scope of the auditor's reporting responsibilities under the MPFSO/ORSO, the General Regulation, the MPF Code and the relevant guidelines issued by the MPFA;
 - b. the extent of the auditor's rights to obtain information and explanations from the relevant employer and/or persons to whom the trustee/administrator has delegated some or all of his duties;
 - c. the fact that the audit will be planned so that there is a reasonable expectation of detecting material misstatements in the financial statements resulting from breaches of trust or statute. It should be made clear, however, that the audit should not be relied on to detect all breaches which may exist; and
 - d. the extent of the auditor's responsibility for information/documents which may be contained in the documents containing the audited financial statements of the scheme.

Planning

16. The auditor plans the audit in accordance with HKSA 300 "Planning an Audit of Financial Statements". Consideration of specific matters related to retirement schemes may also include:
- a. whether the trustee/administrator has a sound understanding of the legislation and rules governing the scheme as set out under the trust deed, the insurance agreement

and/or the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA;

- b. whether the trustee/administrator has the necessary training and skills required to maintain the records of the scheme (both financial and non-financial), given that the trustee/administrator may have to maintain membership records, make investment decisions and administer benefit payments; and
 - c. whether there is close involvement of the employer in a "directly invested scheme". Direct investment is a term used to describe a method of investment for a scheme by which securities are held directly in the name of the trustees.
17. The operation of a retirement scheme can involve complex technical issues and calculations in areas in which the auditor cannot be expected to be expert. During the course of the audit it may be necessary for the auditor to obtain confirmations from other professional advisers such as actuaries, fund managers and solicitors. The audit planning would therefore include details of the advisers and the extent to which reliance would be placed on information provided by them.

Internal controls

18. The auditor considers internal controls in accordance with HKSA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
19. The trustee/administrator has a duty to maintain adequate accounting records and systems to enable his duties to be carried out including discharging his responsibilities for investment decisions and safeguarding the scheme's assets.
20. The nature and extent of a scheme's accounting systems, procedures and internal controls depend mainly upon the size of the scheme, the extent to which the trustee/administrator delegates the administration of the scheme to third parties and the nature of its investments.
21. Where a trustee/administrator delegates the management of a significant part of the scheme's operations to a third party, the auditor considers the requirements of HKSA 402 "Audit Considerations Relating to an Entity Using a Service Organization". In particular, the auditor would need to assess the systems and controls the trustee/administrator has in place to monitor and control the activities of the third party, and those of the third party itself. This may involve corresponding with the auditor of the third party.
22. Where some or all of the scheme is administered in-house, the size of the scheme and the size of the employer's operations determine the scope for developing internal controls and therefore whether formalised procedures and internal controls for certain transactions exist. For example, in a small scheme the infrequency of particular types of transactions such as benefits payable on the death in service of members, may result in no formal control being in place. It may also be difficult for the trustee/administrator to achieve a proper segregation of duties. In such instances, it is unlikely that the auditor is able to place reliance on those internal controls.

Computer systems

23. The auditor considers the requirements of HKSA 315 and also to the matters set out in paragraph 24 below.
24. The processing and recording of a large number of scheme member records and related transactions frequently involve the use of computer systems. Typical examples of scheme administration functions that are performed by computerised procedures include:
- a. calculation of contributions receivable;

- b. calculation of benefits payments and vested benefits;
- c. generation of computer cheques for benefit payments;
- d. allocation of investment income and expenses; and
- e. scheme accounting function.

Review of actuarial information

General

- 25. The requirement for actuarial reviews only applies to defined benefit schemes. Under a defined contribution scheme the vested benefit (the member's contributions and a proportion of the employer's contributions plus the net investment return on both) is more readily identifiable from the scheme's accounting records.
- 26. Without actuarially determined disclosures in the financial statements of a defined benefit scheme, the financial statements only give limited information about the state of affairs of the scheme. Actuarial reviews are necessary to assess, amongst other things, the ability of the scheme to pay the defined benefits in the future.
- 27. The ORSO (section 31) requires an actuarial review to be performed at least once every three years and the report to be given to the administrator within six months of the date at which the review takes place. However schemes where solvency is an issue require a review every year. The primary purpose of this review is to monitor the solvency and funding of the scheme.
- 28. Accordingly, the full actuarial certificate arising from this review is required by the ORSO (schedule 2) to include the following statements:
 - a. that, in the course of the actuarial review, the actuary has had regard to the financial condition of the scheme;
 - b. that the assets of the scheme were (or, in the case of a qualified certificate, were not) sufficient to meet its aggregate vested liability at the valuation date;
 - c. that, following his review, the actuary has made recommendations as regards funding of the scheme;
 - d. that, following his review, the actuary has received a copy of a written undertaking by the relevant employer of the scheme to the administrator of the scheme that he will contribute to the scheme's funds in accordance with those recommendations; and
 - e. that, provided the scheme is funded in accordance with the actuary's recommendations the actuary would expect that the scheme's assets would be sufficient to meet its aggregate vested liability throughout the next three years, and, at a specified date, they would be sufficient to meet the scheme's aggregate past service liability.
- 29. In the event that a qualified actuarial certificate is issued, the auditor is advised to refer to Part 2 of Schedule 2 to the ORSO (which details information to be given by the actuary).
- 30. In addition to the statutory requirements set out above, actuarial reports can provide an assessment of a defined benefit scheme's progress in achieving its objective of providing members' future benefits. The results of an actuarial review are used to determine the appropriate contribution level and to indicate any surplus or deficiency in the funding of the retirement scheme.

31. A practical way of showing the level of funding of a scheme is for the actuary to indicate the trend in the values of the following from the latest valuation and from previous valuations, if they are available:
- a. the amount of aggregate vested liabilities; and
 - b. the amount of aggregate past service liabilities.

32. The actuary arrives at the actuarial valuation by taking the discounted value of future benefits that are expected to arise in the scheme in respect of members, and comparing this with the value of scheme assets, and the discounted value of future contributions. The actuary would also compare scheme assets with past service liabilities and vested liabilities. In doing so the actuary makes a number of assumptions, including earnings rate, inflation, salary increases and staff turnover rates.

The auditor's responsibilities

33. In considering the work of the actuary as audit evidence, the auditor considers the requirements of HKSA 500 "Audit Evidence" on information produced by a management expert.
34. As set out in paragraph 8 of HKSA 500, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor is required to perform the following procedures:
- a. Evaluate the competence, capabilities and objectivity of that expert;
 - b. Obtain an understanding of the work of that expert; and
 - c. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Further guidance are set out in paragraphs A37 to A48 of HKSA 500. Additional specific considerations which apply in the audit of retirement schemes are set out below in paragraphs 35 to 39 below.

35. In evaluating the work of an actuary, the auditor is required to consider the following:
- a. the source data used;
 - b. the assumptions and methods used and their consistency; and
 - c. the results of the expert's work in the context of the auditor's overall knowledge.
36. The auditor would need to be satisfied as to the accuracy and reasonableness of the source data. The source data used is provided by the administrator and includes information on salaries, date of birth of members, date of joining the employer, date of joining the scheme, contribution rates, accumulation of member and employer contributions, benefit multiples and investments held.
37. The assumptions used comprise both ones which pertain to the scheme and the industry in which the scheme operates and ones which are used by actuaries generally, such as inflation and interest rates.
38. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the actuary. The auditor does not have the same expertise and, therefore, cannot always challenge the actuary's assumptions and methods. However, the auditor seeks to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.

39. The auditor would also consider the consistency of the actuary's assumptions and the funding method used to calculate the members' future benefits. By changing the assumptions and funding method, the valuation changes and this affects the surplus or deficiency in the fund and the required contribution rates. Any such changes in assumptions or funding method should be explained by the actuary. The auditor would also give special attention to the consistency of the margin between the projected returns of the scheme and the projected salary rises. If the results of the actuary's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor would seek to resolve the matter. This may involve discussions with the administrator and the actuary, applying additional procedures, including possibly engaging another actuary.

Deficiency of assets

40. It is not uncommon for some of these calculations to show a deficiency of assets to meet the amount of members' benefits calculated. The auditor would review the actuary's recommendations to determine whether the relevant employer has made contributions to the scheme in accordance with such recommendations. These recommendations may include an increase in the amount of contributions or an extension of the period over which contributions are made.
41. The auditor would need to determine whether a deficiency may imply an inability of the scheme to meet its obligations as and when they fall due. Furthermore, in any year in which an actuarial certificate has not been prepared, the auditor would consider whether economic circumstances have eroded the value of the investments, which might also imply that the scheme may not be able to meet its obligations as and when they fall due. Such uncertainties may give rise to additional disclosure in the financial statements and/or the need to include an explanatory paragraph dealing with a fundamental uncertainty or a qualification in the auditor's report.

Consideration of laws and regulations

42. In accordance with HKSA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor considers the impact of the relevant requirements of the trust deed or scheme rules, the ORSO, the MPFSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA on their audit. As stated in HKSA 250, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The requirements in HKSA 250 are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor's reports

43. The principles set out in HKSA 700 "Forming an Opinion and Reporting on Financial Statements" are applicable to auditor's report on retirement scheme financial statements. For ORSO schemes the auditor's reports are addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's reports would be addressed to the administrator. For MPF schemes the auditor's reports are addressed to the trustee.

Review of trustees' (or administrator's) report/scheme report/investment report

44. The trustees' report, the scheme report and the investment report do not form part of the audited financial statements. However, as they will form part of the same document, the auditor refers to HKSA 720 "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements" concerning the auditor's responsibilities in this area.

Specific audit areas

Investments

General

45. The trustee/administrator is responsible for the process of investing the scheme assets. The trustee/administrator must therefore ensure that investments conform to the requirements of the scheme's rules, restrictions imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA and the general duties and obligations established under trust law.
46. Most schemes allow trustees/administrators a wide range of investment choice. There are however, some restrictions imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA. Examples of such restrictions in respect of MPF and ORSO schemes are included in Parts II and III of this Practice Note respectively.
47. The audit of investment balances in a retirement scheme is essentially no different to the audit of investment balances in any other organisation, except where the trustee/administrator chooses to delegate the management of the investment portfolio to a third party. The audit implications of this situation are discussed in paragraph 21 above.

Audit objectives

48. The auditor would consider whether:
 - a. the investments of a scheme exist and are owned by the scheme;
 - b. all investments of the scheme have been accurately and completely recorded in the books of the scheme;
 - c. the investment policy of the scheme is in accordance with the terms of the scheme rules/trust deed, the MPFSO/ORSO (where applicable), the General Regulation (where applicable), the Exemption Regulation (where applicable), the relevant Rules, guidelines and codes issued by the MPFA;
 - d. all investments are appropriately valued; and
 - e. all investment balances are appropriately classified and disclosed in the financial statements of the scheme.

Contributions

General

49. There are principally two types of contributions, namely:
 - a. employer financed; and
 - b. member financed.

These two categories can be further subdivided. For example, the employer contribution may take the form of a contribution based on a specified rate (by the MPFSO, trust deed or by the actuary), and member contributions may include contribution based on a specified rate, additional voluntary contribution or amounts rolled over from other schemes.

50. The trustee's/administrator's primary responsibility for contributions is to ensure that all contributions due have been paid over to the scheme on a timely basis, and have been recorded to the members' benefit completely and accurately. Specific responsibilities of the trustee/administrator for contributions are included in Parts II and III of this Practice Note below.
51. In fulfilling this responsibility the trustee/administrator must firstly ensure that all new members have been properly admitted to the scheme in accordance with the provisions of the governing rules or trust deed, members who have ceased their membership during the year have been appropriately removed from the membership register, and that details relating to all continuing members are properly carried forward in the scheme records. The trustee/administrator must ensure that all membership records are accurate.
52. The trustee/administrator is required to ensure that both employer and member contributions are made in accordance with the governing rules or other relevant agreements and as recommended by the actuary (in the case of a defined benefit scheme) and such contributions are made on a timely basis.

Audit objectives

53. The auditor would consider whether:
 - a. all contributions receivable from, or on behalf of, eligible members have been received and have been recorded in the correct period; and
 - b. contributions received have been made in accordance with the governing rules or other relevant agreements and, for defined benefit schemes, the recommendations of the actuary.

Specific risk areas

54. The main risks are those of completeness and accuracy. Completeness involves ensuring that all contributions are recorded, either as received or receivable. Accurate calculation is particularly relevant to defined contribution schemes where employer's contributions are based on a percentage of a member's salary. The auditor would also consider whether contributions receivable are recoverable, particularly if the employer has a significant level of contributions owing at the financial year end of the scheme.

Benefits

General

55. Benefits are normally paid by way of a lump sum. The amount and means of calculation of the benefit paid depend on the type of the scheme.
56. Where a scheme is a defined contribution scheme, the benefit paid will equal the members' vested benefit in the scheme which is the accumulation of the members' contributions plus the appropriate proportion of the employer's contributions and the investment return on both.
57. Where the scheme is a defined benefit scheme, the benefit paid is determined by the governing rules and is generally calculated on the basis of length of service and the members' salary, which may be based on current salary, an average salary or another method as determined by the scheme rules.
58. The trustee/administrator is primarily responsible for ensuring that all benefit payments which should have been made are correctly paid to bona fide members in accordance with the governing rules or the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA.

59. In many cases, where an employee leaves an ORSO scheme, part or all of the employer's contributions plus the investment returns thereon in respect of that member may not be paid to the member. These forfeitures may be applied (depending on the rules of the scheme) in reducing the contributions of the employer, retained in the scheme for the benefit of members, or returned to the employer. The same rules will apply to voluntary contributions made by an employer to a MPF scheme.

Audit objectives

60. The auditor would consider whether:
- a. benefits paid and payable are bona fide, have been correctly calculated and have been recorded in the correct period; and
 - b. benefits have been paid in accordance with the scheme rules/trust deed and the MPFSO/ORSO, the Exemption Regulation (where applicable), the relevant Rules, guidelines and codes issued by the MPFA.

Specific risk areas

61. The principal audit risks in relation to benefits are those of completeness and accuracy. Completeness involves ensuring that all benefits are recorded either as paid or payable. Calculation of benefits paid is relevant, particularly with respect to defined benefit schemes, and benefits are paid to people who are not entitled to receive them.

Pooling arrangements

General

62. The ORSO (section 2(4)) permits pooling arrangements to be governed by a trust, provided that it is managed by a registered trust company. All MPF schemes must be governed by trust. The master trust deed sets out, amongst other things, the respective powers and duties of the pool trustee and the administrator. The ORSO (section 2(4)) also permits pooling arrangements to be the subject of or regulated by an insurance agreement (policy). This master policy sets out the respective powers and duties of the administrator, usually the insurer, and the relevant employer.
63. The ORSO (section 2(4)) requires that proper accounts and records are kept with respect to the pooling arrangement and its participating schemes, such that the value of the assets attributable to, and the liabilities of, each of its participating schemes are readily determinable. The General Regulation (section 78) requires that a separate account is established and maintained for each scheme member specifying that member's accrued benefits.
64. Where a scheme is a participating scheme in a pooling agreement, section 21(4A) of the ORSO provides that the asset separation requirement under section 21(1)(a) of the ORSO does not require the separation of the assets of the scheme from the assets of the other schemes vested in the administrator in his capacity as administrator of the pooling agreement.

Audit implications

65. For ORSO schemes, it is the responsibility of the pool administrator to prepare annual financial statements for each scheme participating in the pool, and to have those financial statements audited. The ORSO (section 20(7C)) requires that, unless exempted by the MPFA, the pool administrator appoints the same auditor to audit the financial statements of each scheme participating in the pool and all participating schemes should have a common year end. The trustee of a MPF scheme need not prepare individual financial statements for each participating employer.

66. The participation of a scheme in a pooling arrangement can have specific implications for the auditor as the audit evidence that the auditor requires to form the opinion could be derived from several sources.
67. For example, the pool trustee/administrator may appoint an auditor for the schemes administered by him who are not the auditor appointed by his shareholders to be his statutory auditor. In such instances, the auditor for the schemes would consider the extent to which he/she can rely on the work of the trustee's/administrator's auditor in testing the internal controls and systems of the pooling arrangement. It may be more efficient for the auditor of the schemes to independently assess the controls established by the trustee/administrator over the systems used to produce the scheme financial statements.

Abbreviated information for scheme members

68. Many schemes produce abbreviated financial information for distribution to members which summarises the key financial highlights from the audited financial statements.
69. The auditor has no control over the issue of such abbreviated financial information, particularly, when the auditor is not asked to report on it. However, if the auditor becomes aware that such information has been or will be issued, the auditor would take steps towards ensuring that members are not given the impression that such abbreviated financial information itself constitutes audited financial statements. If the auditor has any concerns in this respect, the auditor would communicate them to the trustee/administrator and the auditor would consider the continuing appointment in the light of the trustee's/administrator's response.
70. If the auditor is asked to provide a report, the same concerns apply, and the auditor would make clear in the auditor's report the scope of the work the auditor has carried out, in particular any areas the auditor has not examined. The auditor would ensure that the report specifically refers to the fact that the financial information does not give a true and fair view and would indicate whether the opinion on the full financial statements had been qualified or not.

PART II ADDITIONAL GUIDANCE RELEVANT TO THE AUDITOR OF A MPF SCHEME

General

71. The reference in this Part to a retirement scheme or scheme means a MPF scheme.

Reporting under sections 102 and 106 of the General Regulation

72. Section 95 of the General Regulation requires the trustee to submit the financial statements of the scheme to an auditor annually, for the purpose of independent audit. All schemes, regardless of size or type, must be audited. A copy of the audited financial statements of the scheme is required to be submitted by the trustee to the MPFA within 6 months after the end of the scheme's financial period.

73. The first audit would be required in respect of the first financial period which should commence with the date on which the scheme was first registered under section 21 or 21A of the MPFSO and end on a date not more than 12 months from this date.

Specific audit areas

Investments

74. Under section 28 of the MPFSO, the MPFA has the authority to publish guidelines on forbidden investment practices in relation to a scheme.

75. The General Regulation imposes the following requirements in respect of investment of scheme assets:

- a. a capital preservation fund must comply with the investment restrictions as set out in section 37(2) of the General Regulation;
- b. a scheme cannot enter a repurchase agreement unless it complies with the restrictions as set out in section 51 of the General Regulation;
- c. a scheme cannot lend any securities unless it complies with the restrictions as set out in section 52 of the General Regulation;
- d. an employer sponsored scheme is not allowed to invest more than 10% of the total assets of each constituent fund in "restricted securities" or make a loan other than a loan by way of a deposit with an authorised financial institution (General Regulation Part X);
- e. a scheme must comply with Schedule 1 to the General Regulation which deals with "permissible investments", "currency exposure" and "pooled investment". The general restrictions for investments for a scheme are:
 - i. no more than 10% of the total funds of a constituent fund may be invested in securities and other permissible investments issued by any one person (General Regulation Schedule 1 section 2(1)); and
 - ii. no more than 10% of securities or other permissible investments of a particular class issued by one person may be acquired for the purposes of a constituent fund (General Regulation Schedule 1 section 2(2)).

The general restrictions for investments set out above are not applicable when the investment is made into approved pooled investment funds¹. (The reporting and investment requirements of approved pooled investment funds are set out in relevant guidelines and the MPF Code issued by the MPFA.)

76. The General Regulation (Schedule 1 section 17) states that funds may be invested in a pooled investment fund, which may in turn be invested in one or more other pooled investment funds. Where the trustees of these pooled investment funds and the scheme are not the same, the auditor of the scheme would need to ensure that the trustee has monitoring procedures in place over the trustees of the pooled investment funds. These procedures may include:
- a. obtaining a copy of the report of internal controls and the accompanying auditor's report of the trustees of the pooled investment funds;
 - b. obtaining regular statement of compliance from the trustee that the investment restrictions are not breached; and
 - c. obtaining a copy of the financial statements of the trustee and of the pooled investment funds.
77. The auditor would need to perform such procedures as are considered necessary in order to obtain sufficient appropriate audit evidence to enable the auditor to report whether or not the requirements of section 28 of the MPFSO and sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with as at the end of the financial period and 2 other dates as the auditor preparing the auditor's report may elect, provided that the intervening period between the 2 other dates shall not be shorter than three months. Where a scheme has been in operation for less than a full year and the intervening period between the 2 other dates nominated is less than 3 months, approval must be obtained from the MPFA in writing to use those dates. In planning and performing this work, the auditor should refer to the principles in the Hong Kong Standard on Assurance Engagements (HKSAE) 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" applicable to assurance engagements.

Contributions

78. In respect of completeness of contributions under MPF, section 106(2) of the General Regulation states that information contained in a remittance statement submitted by an employer or particulars given by a self-employed person to the trustee shall be treated as conclusive evidence as to the amount of the member's relevant income. Accordingly, the auditor need not carry out further procedures to satisfy himself/ herself in respect of the completeness of the relevant income.

The auditor's reports

79. Section 102 of the General Regulation requires:
- a. the auditor's report, addressed to the trustee, in relation to the financial statements of a scheme and a financial period of it to state whether or not in the auditor's opinion:
 - i. the financial statements give a true and fair view of the financial position of the scheme as at the end of the period and of the financial transactions of the scheme for the period then ended; and
 - ii. the financial statements have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 of the General Regulation; and

¹ An example of an auditor's report for an approved pooled investment fund is included as Example 9 of Appendix 1 to this Practice Note.

- b. the auditor's report, addressed to the trustee, on a scheme's compliance with certain requirements of the MPFSO and General Regulation to state:
- i. whether or not in the auditor's opinion:
 - proper accounting and other records have been kept during the relevant financial period in respect of the constituent funds of the scheme, the scheme assets and all financial transactions entered into in relation to the scheme; and
 - the requirements specified in the guidelines made by the MPFA under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with in all material respects as at the end of the period and two such other dates in the period as the auditor preparing the auditor's report may elect, provided that the intervening period between such dates shall not be shorter than three months, or a shorter period allowed by the MPFA; and
 - ii. whether or not the assets of the scheme as at the end of the period were subject to any encumbrance, otherwise than as permitted by the General Regulation.
80. In addition, section 106 of the General Regulation requires the auditor to state whether the auditor has obtained all the information and explanations that the auditor has required.
81. Example auditor's reports are included in Appendix 1 to this Practice Note (examples 1 and 2).

Reporting under sections 18 and 115 of the General Regulation

Prescribed capital adequacy requirements

82. The MPFA requires all applicant trustees to meet the prescribed capital adequacy requirements (capital adequacy requirements) when applying for approval as trustee, and all trustees to comply with the capital adequacy requirements at all time.
83. The MPFSO (sections 20A and 20B) empowers the MPFA to suspend or revoke the approval of a trustee for failure to meet financial resources requirements, including capital adequacy requirements.
84. There are essentially two means by which a company can meet the capital adequacy requirements. These are referred to in this Practice Note as "the stand-alone basis" and "the group basis".
85. The stand-alone basis sets requirements for the company itself as follows:
- a. paid up share capital of at least \$150,000,000 (or its foreign currency equivalent);
 - b. net assets of at least \$150,000,000 (or its foreign currency equivalent); and
 - c. assets in Hong Kong of at least \$15,000,000.
86. "Assets in Hong Kong" is defined in section 10 of the General Regulation.

87. The alternate basis of meeting the capital adequacy requirements is the group basis. In this case the applicant trustee must be an associate of:
- a. a company or corporation that is a substantial financial institution (as defined by section 7 of the General Regulation) which provides continuous financial support (as defined under section 12 of the General Regulation) to the applicant trustee; or
 - b. a company or corporation having a subsidiary that is a substantial financial institution and provides continuous financial support to the applicant trustee.
88. Under the group basis, the applicant trustee is only required to maintain paid up share capital and net assets of \$30,000,000. The \$15,000,000 "assets in Hong Kong" requirement must still be met in full.
89. The substantial financial institution must itself have:
- a. a paid up share capital of at least \$150,000,000 (or its foreign currency equivalent) and net assets of at least the same amount. In the determination of net assets, certain subordinated debts may be excluded by virtue of section 7(2) of the General Regulation; and
 - b. given a written undertaking in a form acceptable to the MPFA to the extent that it commits itself to provide financial support to the applicant trustee such that the \$30,000,000 share capital and net asset position of the applicant trustee and the associate relationship between the institution and the trustee will be maintained. A written undertaking under section 12 of the General Regulation needs to be by deed or like form.

Procedures performed by the auditor

90. For the auditor's reports under sections 18 and 115 of the General Regulation, in planning and performing the work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.
91. For the purposes of the auditor's report on the capital adequacy requirements of an applicant trustee, unless the date agreed between the applicant trustee and the MPFA is the financial year end of the applicant trustee, the auditor will be required to design substantive procedures at the date specified to enable the auditor to report whether or not the capital adequacy requirements have been complied with.
92. Such substantive procedures may include:
- a. obtaining evidence to support the amount of paid up share capital at the reporting date;
 - b. obtaining a balance sheet of the applicant trustee at the reporting date and reviewing the net asset position of the applicant trustee at that date;
 - c. obtaining evidence to support the existence of assets at the reporting date and the basis on which the assets are valued at that date;
 - d. extending existence testing of assets to verify the requirements for assets in Hong Kong are being met;
 - e. searching for unrecorded liabilities at the reporting date;
 - f. reviewing transactions before and after the balance sheet date to consider the reasonableness of the presentation of the balance sheet position at the reporting date;

- g. obtaining and reviewing the written undertaking in respect of continuous financial support as specified under section 12 of the General Regulation.

If a group basis of meeting the capital adequacy requirements is chosen, the auditor would obtain evidence that the institution supporting the applicant trustee qualifies under the General Regulation and, where necessary, evidence of appropriate approval by the MPFA is provided.

- 93. If the reporting date is to be the financial year end of the company and the company is required to prepare financial statements which have been audited, then the auditor would have regard to the extent of the substantive tests performed for the audit of the financial statements in the consideration of the extent of the procedures in paragraph 92 above to be carried out.
- 94. For the purposes of the reporting on ongoing capital adequacy requirements, the auditor would plan to include the procedures suggested in paragraph 92 above in respect of the financial year end and the two dates selected to test the compliance with capital adequacy requirements in the audit work. However, there are other matters which the auditor may consider in forming the opinion:
 - a. the frequency by which management accounts or other financial information is prepared may influence the dates chosen by the auditor, especially if the audit procedures adopted plan to place reliance on the controls surrounding the preparation and review of the management information;
 - b. the auditor may choose to rely on the internal control processes adopted by the trustee in ensuring that capital levels can be monitored at all times, and test the controls in place in conjunction with a series of substantive tests.

The auditor's reports pursuant to sections 18 and 115 of the General Regulation

- 95. The General Regulation (section 18) requires that any applicant trustee applying to be an approved trustee must cause a report to be prepared by its auditor. The auditor's report is addressed to the applicant trustee and must state, in the opinion of the auditor, whether or not the applicant trustee complies with the capital adequacy requirements, as set out in section 11 of the General Regulation, on a specified date (agreed between the MPFA and the applicant trustee). The date referred to must be on or before the date on which the MPFA approves the applicant trustee as a trustee.
- 96. The auditor's report may contain such observations, elaborations, qualifications or explanations as the auditor considers necessary. The MPFA has the power to request remedial action by the applicant trustee within a specified time period. In such circumstances a second auditor's report would be required to be prepared by the auditor, stating whether or not in the auditor's opinion the qualification or matter raised has been rectified.
- 97. With respect to the ongoing capital adequacy requirements, section 114 of the General Regulation requires that the trustee prepares a report to the MPFA, stating whether or not the capital adequacy requirements were complied with throughout the period. If the requirements were not complied with, the reasons for non-compliance should be stated in the trustee's report.
- 98. Section 115 of the General Regulation requires the auditor to review the section 114 report issued by the trustee and issue an auditor's report, stating whether or not, in the auditor's opinion, the capital adequacy requirements were complied with at the financial year end of the approved trustee, and two other dates during the financial year, such dates being selected by the auditor. The two dates selected must be at least three months apart or such a shorter period the MPFA may allow. If the requirements were not met, the reasons for non-compliance are required to be stated in the auditor's report.

99. Both reports under sections 114 and 115 are to be submitted to the MPFA within six months of the financial year end of the trustee. In practice the requirements of sections 114 and 115, when taken together, will mean that the trustee will be required to prepare a draft section 114 report in time for the auditor to review and attach the auditor's report under section 115.
100. Suggested reports suitable for reporting on compliance with prescribed capital adequacy requirements are included in Appendix 1 to this Practice Note (examples 3 and 4).

Reporting under section 74(5)(b) of the General Regulation

Trustee to review service providers' reports

101. In accordance with section 74 of the General Regulation, the trustee requires each service provider appointed or engaged by the trustee to report any material breach of obligations or material changes to the trustee.
102. On an annual basis, the service provider is required to submit to the trustee within four months after the scheme's year end date, the audited financial statements together with a report from its auditor stating whether or not, in the auditor's normal course of duties², the auditor has become aware of:
- a. any failure of the service provider to comply with the service provider's obligations under the contract of appointment or engagement entered into between the trustee and the service provider; and
 - b. any false declaration made by the service provider to the trustee or any other person, and if so, give particulars of the failure or false declaration.

The auditor's report pursuant to section 74(5)(b) of the General Regulation

103. A copy of an example auditor's report as mentioned in paragraph 102 above is included in Appendix 1 to this Practice Note (example 5).

Reporting under section 113 of the General Regulation

Trustee's report on control objectives and internal control measures

Requirements of trustee

104. The MPFA requires all trustees to maintain an appropriate internal control framework with respect to the management and administration of schemes. Trustees are also required to submit an annual report to the MPFA on their control objectives and internal control measures (Trustee's Report).
105. Reference would be made to section 39 of the General Regulation for details of the control objectives and internal control measures that must be established for each scheme and be maintained at all times while the scheme is registered.
106. Certain schemes may be exempted from these requirements. Reference would be made to the relevant regulation for further information.
107. The General Regulation specifies the requirements for trustees to report to the MPFA and reference would be made to the General Regulation for details of these requirements. A Trustee's Report would normally set out:
- a. a statement of responsibility;

² The auditor should obtain management representation specifically for reporting under section 74(5)(b) of the General Regulation.

- b. the trustee's control objectives in relation to the safeguarding of scheme assets, the recording of transactions and the compliance with the General Regulation;
 - c. details of each of the specific control procedures and measures designed to achieve the control objectives;
 - d. details of any significant changes to the control objectives, procedures and measures during the period;
 - e. details of any exceptions to the control objectives, procedures and measures during the period; and
 - f. an assertion by the trustee that it has reviewed the control objectives, and the control procedures and measures in operation.
108. In order that the statement by the trustee is fairly described, the trustee should include in the Trustee's Report a description of any material weaknesses identified which have, in its view, affected whether control procedures and measures are in place, or reduced the effectiveness, or prevented the operation, of control procedures and measures, if those weaknesses were not themselves identified and rectified within an appropriate time.

Requirements of the auditor

109. The MPFA requires the Trustee's Report on internal controls to be reviewed by the auditor (section 113 of the General Regulation), and the auditor is required to report to the trustee:
- a. whether or not appropriate control objectives were established and maintained for the scheme during the period to which the report relates;
 - b. if appropriate control objectives were so established and maintained, whether or not effective internal control measures were established and maintained for the purpose of achieving those objectives; and
 - c. whether or not those internal control measures (if any) were likely to have been sufficiently effective to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented.
110. The auditor is also required to state:
- a. whether or not, during the course of the review of the Trustee's Report, the auditor became aware of any shortcomings in the internal control measures that could materially affect the operation of the scheme (including its financial position) or the financial interests of scheme members; and
 - b. details of any such shortcomings the auditor became aware of.

Requirements of both the trustee and auditor

111. Both the Trustee's Report and the auditor's report on a review thereof under sections 112 and 113 of the General Regulation respectively are submitted to the MPFA in accordance with section 111 of the General Regulation. In practice the requirements of sections 112 and 113 of the General Regulation when taken together, will mean that the trustee will be required to prepare a draft Trustee's Report in time for the auditor to review and attach the auditor's report thereto under section 113 of the General Regulation.
112. The MPFA has issued guidelines relating to the reporting requirements of the trustee and auditor in respect of the internal control objectives and control measures for each scheme in "Guidelines on Internal Control Report for each Registered Scheme" ("MPFA Guidelines II.6").

113. It is recognised that the control objectives and procedures may differ from trustee to trustee depending on the trustee's own assessment and tolerance of the risk level in the organization, its specific operating system, size of the business, types of products on offer etc.
114. The MPFA Guidelines II.6 is not intended to prescribe specific control systems for all schemes and the measures described in the MPFA Guidelines II.6 are not intended to be exhaustive and in many instances alternative control procedures and measures may be equally appropriate and acceptable.
115. Even though trustees are not required to report on all the control objectives and measures applicable to their schemes, trustees are expected to ensure that a proper system of internal controls is in place for all aspects of their schemes' operations and are expected to ensure that as a minimum the requirements specified by the MPFA are complied with.
116. The auditor is expected to report on the design effectiveness of the internal controls and is therefore not expected to test or ascertain whether the control objectives or internal control measures were actually implemented during the period.
117. It is recognised that the auditor of the trustee may be different from the auditor of the scheme. It is also possible that different auditors may be appointed to each scheme managed by the same trustee.
118. If the Trustee's Report relates to only one scheme, then the Trustee's Report is submitted to the auditor of the scheme for review.
119. If the Trustee's Report relates to 2 or more schemes and the trustee specifies the financial period of one of the schemes to which the report relates as the relevant period nominated under section 111(1)(b) of the General Regulation, then the Trustee's Report is submitted to the auditor of that scheme for review.
120. If the Trustee's Report relates to 2 or more schemes and the financial year of the trustee is the relevant period nominated under section 111(1)(b) of the General Regulation, then the Trustee's Report is submitted to the auditor of the trustee for review.

Procedures performed by the auditor

121. In planning and performing this work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.

Terms of engagement

122. In agreeing the terms of the engagement, the auditor would exclude liability in respect of any loss or damage caused by, or arising from, fraudulent acts, misrepresentation or wilful default on the part of the trustee, its directors, employees or agents. The auditor would also exclude liability to third parties. They would normally obtain a limitation in aggregate of the auditor's liability. It should be noted that it is not possible to limit liability in relation to death or personal injury caused by the negligence (within the meaning of section 2 of the Control of Exemption Clauses Ordinance) of the auditor.

Planning the engagement

123. In addition to the requirements contained in HKSAE 3000, the following would need to be considered by the auditor:
 - a. the structure with respect to a scheme operation may be different for each scheme. The auditor would need to understand the structure adopted in the administration and management of the scheme, i.e. who is and what are the custodian's responsibilities, who is and what are the trustee's responsibilities etc;

- b. the terms of the contract between the trustee and service providers such as the custodian, third party administrator and the investment manager of the scheme;
- c. the nature of services provided by the service providers and the extent to which the trustee's internal control measures interact with those of the service providers;
- d. the methods adopted by the trustee to evaluate the appropriateness of the specified control objectives of the scheme and the effectiveness of the major procedures and internal control measures for achieving those objectives;
- e. the type and extent of evidence supporting the trustee's evaluation/assertion about the effectiveness of the internal control procedures and measures;
- f. the nature of control procedures relevant to the responsibility of the trustee in ensuring that a proper system of internal controls is in place for all aspects of the scheme's operation; and
- g. matters affecting the industry, such as financial reporting practices, economic conditions, amendments to ordinances and regulations and technology changes.

Situations where part of the trustee's responsibilities are outsourced to a third party

124. The ultimate responsibility with respect to the implementation of, and ongoing compliance with, the necessary internal controls framework rests with the trustee. Where a trustee has delegated certain of its functions to another service provider, the auditor needs to consider the impact of this on the overall engagement with reference to HKSA 402 "Audit Considerations Relating to an Entity Using a Service Organization".

Evaluating design effectiveness

125. To evaluate the effectiveness of control procedures, the auditor would obtain a general understanding of the control environment and information system to identify matters that are likely to have a significant impact on the effectiveness of particular control procedures and measures.
126. Procedures to evaluate the effectiveness of a specific control are concerned with whether that control is suitably designed to comply with the suggested control measures in the MPFA Guidelines II.6. Such procedures will vary depending upon the nature of the specific control, the nature of the trustee's documentation of the specific control, and the complexity and sophistication of the trustee's operations and systems.
127. The auditor would evaluate the effectiveness of the control procedures based on the identified control objective. This evaluation would be based on whether the control procedures have been suitably designed to reduce to an acceptably low level the risks that threaten achievement of the objectives relevant to the area of activity. Where the auditor is unable to identify control procedures designed to provide reasonable assurance about the reduction of risk, this would constitute a weakness in relation to design effectiveness.
128. The auditor would focus on the significance of controls in achieving the control objectives rather than on specific controls in isolation. The absence or inadequacy of a control designed to achieve specific criteria may not be a deficiency if other controls specifically address the same criteria.

Testing operating effectiveness

129. It is recognised that the auditor cannot be aware of all the relevant control assertions made by the trustee in its report on internal controls, in particular as these might be affected by the other service providers' control procedures. The auditor does not have the responsibility to identify or test all the control objectives and procedures which have been included in the description of the control report prepared by the trustee and the auditor is not expected to test

or ascertain whether the control objectives or internal control measures were actually implemented during the period under review.

130. However it is envisaged that in order to enable the auditor to form an opinion on the design effectiveness and on whether those internal control measures were likely to have been sufficiently effective to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented, the auditor would be required to carry out a limited level of testing.
131. These tests would ordinarily include procedures such as enquiries of appropriate personnel, inspection of relevant documentation, observation of the trustee's operations, and reapplication of, and reperformance of, the control measures to a certain extent.
132. Tests of operating effectiveness are concerned with how the control procedures were applied, the consistency with which they were applied, and by whom they were applied. The auditor would also need to consider the period of time over which the control procedures were applied.
133. The nature of a control procedure often influences the nature of tests of operating effectiveness that can be performed. For example, the auditor may examine evidence regarding a control where such evidence exists, however documentary evidence regarding some control procedures often does not exist. In these circumstances, the tests of operating effectiveness may consist of enquiry and observation only.
134. The decision about what comprises sufficient appropriate evidence is a matter of professional judgement. The auditor would consider for example:
 - a. the significance of the control procedure in achieving the relevant objective; and
 - b. the nature and extent of any tests of operating effectiveness performed by the trustee (management, internal auditing or other personnel).
135. Management, internal auditing or other personnel of the trustee may provide the auditor with the results of their tests of the operating effectiveness of certain aspects of internal control. Although the auditor would consider the results of such tests when evaluating operating effectiveness, it is the auditor's responsibility to obtain sufficient appropriate evidence to support the auditor's conclusion and, if appropriate, corroborate the results of such tests. When evaluating whether sufficient appropriate evidence has been obtained, the auditor would consider that evidence obtained through direct personal knowledge, observation, re-performance (to a limited extent only), and inspection is more persuasive than information obtained indirectly, such as from management, internal auditing or other personnel of the trustee. Furthermore, judgements about the sufficiency and appropriateness of evidence obtained and other factors affecting the auditor's conclusion, such as the significance of identified control weaknesses, are those of the auditor.

The auditor's report pursuant to section 113 of the General Regulation

136. The auditor's report is addressed to the trustee.
137. The auditor's report depends on the specific terms of engagement agreed with the trustee, but it is normally expected to contain:
 - a. the title;
 - b. the addressee;
 - c. a statement as to the scope of the auditor's work;

- d. a section dealing with the respective responsibilities of the trustee and auditor:
 - i. if not included in the Trustee's Report, a statement that it is the responsibility of the trustee to design, implement and maintain the control procedures. It should also specify that it is the trustee's responsibilities to ensure adequate controls are implemented in the monitoring of other service providers where some or all of the trustee's responsibilities have been outsourced to a third party; and
 - ii. the auditor's responsibilities;
 - e. a section dealing with the basis of conclusion:
 - i. a statement that the engagement was conducted in accordance with HKSAE 3000 and with reference to this Practice Note;
 - ii. a statement that the auditor is not required to verify whether the controls were in fact implemented during the period under review and that the auditor have performed very limited tests on the control procedures; and
 - iii. a statement that the auditor's work was limited to ensuring whether control measures designed by the trustee were in line with those recommended in the MPFA Guidelines II.6;
 - f. a statement that all control systems have inherent limitations and accordingly, errors and irregularities may occur and not be detected. Also, they cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust;
 - g. the auditor's conclusion:
 - i. a statement as to whether or not appropriate control objectives were established and maintained for the scheme during the period to which the report relates;
 - ii. a statement as to whether or not effective internal control measures were established and maintained for the purpose of achieving those objectives during the period to which the report relates; and
 - iii. a statement as to whether or not those internal control measures (if any) were likely to have been sufficiently effective, in all material respects, to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented;
 - h. a statement as to whether or not, during the course of the review of the Trustee's Report, the auditor became aware of any shortcomings in the internal control measures that could materially affect the operation of the scheme (including its financial position) or the financial interests of scheme members;
 - i. details of any such shortcomings that the auditor became aware of; and
 - j. a statement as to the intended use of the report.
138. A suggested auditor's report suitable for such an engagement is included in Appendix 1 to this Practice Note (example 6).

Report modifications

139. The auditor would modify the auditor's report if any of the following conditions exist:
- a. there is a material weakness in the internal controls;
 - b. there is a restriction on the scope of the engagement; or
 - c. the trustee presents an assertion about only a segment of the internal controls, and not all the control objectives and control procedures as outlined in the General Regulation and the MPFA Guidelines II.6 are included in the Trustee's Report.

Reporting material weaknesses in the internal controls

140. Where the auditor has become aware of material weaknesses which are inadequately described in the Trustee's Report, the auditor would need to issue a modified conclusion in the auditor's report and provide such a description in the auditor's report or a reference to such a description in the Trustee's Report. The auditor would also refer to any inaccurate or inadequate description of the trustee's control procedures in the Trustee's Report of which the auditor has become aware. It would also be helpful for the status of any corrective action taken by the trustee in relation to any reported weakness to be included in the auditor's report.
141. On occasions the trustee may seek to alter control objectives in order to prevent a modification in the report by the auditor. The auditor would assess carefully the appropriateness of any changes proposed to the Trustee's Report and the risks arising from this and consider the conclusion in the light of that assessment.
142. The trustee may express its intention to rectify a weakness at some future time. No conclusion would be given by the auditor in relation to such an expressed intention and the auditor's report would specifically state that fact. The auditor may, at the request of the trustee, test and report on any corrective action taken in respect of a weakness.
143. The engagement is not intended to be planned and carried out in such a way that all control weaknesses that may possibly exist within the trustee can be identified during the course of the engagement. Furthermore as the auditor is not expected to test whether the control objectives and internal control measures were actually implemented during the period under review, the auditor cannot be expected to identify all control weaknesses that may possibly exist within the trustee's operation over the management and administration of schemes. This limitation must be clearly stated in both the engagement letter and the auditor's report.
144. However the auditor would also consider the statutory requirements to report material weaknesses to the MPFA (see paragraphs 147 to 151 below).
145. During the course of the engagement, if the auditor becomes aware of significant deficiencies in the trustee's system of internal control, to the extent that the shortcomings identified during the course of the auditor's work may materially affect the operation and financial position of the scheme. The auditor is required to include details of the shortcomings of which the auditor became aware in the report.
146. The auditor's conclusion is based on the procedures determined to be necessary for the collection of sufficient appropriate evidence, that evidence being persuasive rather than conclusive in nature. The assurance provided by the auditor on the effectiveness of internal controls is however restricted because of the nature of internal controls and the inherent limitations of any set of internal controls and their operations. These limitations include:
- a. the trustee's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived;
 - b. most internal controls tend to be directed at routine rather than non-routine transactions/events;

- c. the potential for human error due to carelessness, distraction or fatigue, misunderstanding of instructions and mistakes in judgement;
- d. the possibility of circumvention of internal controls through the collusion of employees with one another or with parties outside the trustee;
- e. the possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding a control procedure;
- f. the possibility that management may not be subject to the same internal controls applicable to other personnel; and
- g. the possibility that internal controls may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Communications between the auditor and the MPFA

Ad hoc reports to the MPFA under section 103 of the General Regulation

147. Section 103 of the General Regulation requires the auditor to report the following matters to the MPFA in writing, if the auditor becomes aware of them while performing the duties:
- a. any matter that would cause the auditor to qualify the auditor's report on the financial statements of the scheme;
 - b. non-compliance with the following sections of the General Regulation:
 - i. keeping proper accounting records (section 77); and
 - ii. keeping a separate account for each scheme member (section 78);
 - c. any transaction that has resulted in a misappropriation of the funds of the scheme or the scheme assets;
 - d. any payment from the funds of the scheme that is materially prejudicial to the interests of scheme members except where the trustee has fully reimbursed the scheme after the payment has been brought to the notice of the trustee;
 - e. any combining of the scheme assets with the funds of the trustee or the assets of any persons except where the custodian:
 - i. also holds the assets of one or more other scheme(s) or other financial schemes or undertakings; and
 - ii. keeps a separate account of the scheme assets and those other assets in such a way as to enable them to be separately identified;
 - f. non-compliance with the legislation and guidelines on forbidden investment practices;
 - g. non-compliance with section 135 of the General Regulation which requires the trustee to inform the MPFA in writing within 7 days after the end of the settlement period of non-payment of or discrepancy in mandatory contribution.
148. The auditor has no obligation to seek out grounds for making a report under section 103 of the General Regulation, nor does the section place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover a matter upon which the MPFA may need to act. It is only when the auditor does become aware in the

ordinary course of the work of such a matter, or of circumstances which suggest the existence of such a matter, that the auditor would consider reporting under this section.

149. In the event that the auditor becomes aware of any matters in paragraph 147 above, the auditor may bring the matter to the trustee's attention in writing and request an explanation of the matter. The trustee is required to rectify the situation within such period as the auditor considers to be reasonable. If the trustee complies with the auditor's request in this respect, the auditor is not required to report the matter to the MPFA. However, the auditor must not give such notice:
- a. if the matter relates to a transaction, which in the opinion of the auditor, is or has resulted in a material misappropriation of the funds of the scheme or the scheme assets; or
 - b. if bringing the matter to the attention of the trustee could reasonably be expected to detrimentally affect the interests of the scheme members.
150. If on becoming aware of matters reported in accordance with paragraph 147 above, the MPFA is of the opinion that the matter is capable of being rectified, the MPFA may ask the trustee to rectify the matter. As soon as practicable after giving such a direction, the MPFA will request the auditor in writing to provide the MPFA with a further report as to whether or not the trustee has rectified the matter.
151. If upon receiving a request in writing from the MPFA to provide to them a further report as to whether or not the trustee has rectified the matter as specified in the letter, the auditor must as soon as practicable after the end of the period specified in the notice and at the expense of the trustee, issue such a report to the MPFA.

Statutory protection under section 42A of the MPFSO

152. The MPFSO (section 42A) introduces statutory protection for current and prior auditors from liability to their client for breach of confidentiality. Such statutory protection is available when the auditor communicates directly with the MPFA (whether or not in response to a request of the MPFA) in good faith, if the auditor became aware of the matter in the capacity as the auditor and on matters relevant to a function of the MPFA.
153. Section 42A of the MPFSO does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the MPFA. It provides a statutory mechanism whereby the auditor may make matters known to the MPFA without breaching the duty of confidentiality.
154. Confidentiality is an implied term of an auditor's contract with the client, but in certain circumstances and under conditions specified in section 42A of the MPFSO it does not prevail, since the auditor is entitled to communicate information or opinions on a matter relating to the business or affairs of the client relevant to the MPFA's functions without the duty of confidentiality owed to the client being regarded as having been breached.
155. Examples of circumstances in which the auditor may communicate a matter to the MPFA under section 42A of the MPFSO include:
- a. the auditor considers scheme members have incurred, or are at significant risk of incurring, a material loss as a result of a trustee carrying on business in a manner that is not fit and proper or that is in breach of the MPFSO or the General Regulation;
 - b. there is evidence of:
 - i. fraud, dishonesty or serious incompetence; or

- ii. serious failure to observe requirements of the MPFSO or the General Regulation or conditions imposed on the trustee by the MPFA if such failure impacts scheme members;
 - 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, requirements set by the MPFA to which the trustee or the scheme is subject; and
 - d. the position is such that because of a significant risk which is material to the collective interests of scheme members, the scheme members' interests would be better safeguarded if the MPFA were aware of the position.
156. Clearly the potential nature of matters which may be reported is very wide, but as explained in paragraph 159 below this does not, of itself, require the auditor to extend the scope of the work in order to discover matters and it will only be in exceptional circumstances that the auditor may choose to seek statutory protection.
157. Any protected communication can be made either on the auditor's initiative or in response to a request from the MPFA for information. The auditor would normally co-operate with the MPFA and respond to any requests from the MPFA for information, provided the auditor has no reason to doubt that the request is relevant to the MPFA's functions. The auditor may communicate a matter to the MPFA with the protection of section 42A of the MPFSO regardless of the source of that information, provided the auditor became aware of the matter in the capacity as the auditor of the scheme and the auditor does so in good faith.
158. Matters of which the auditor becomes aware "in the capacity as the auditor" may not be restricted to those matters identified by the auditor during the course of the audit work. The auditor may become aware of a matter which is relevant to the functions of the MPFA during the course of the work for the trustee 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 MPFA 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.
159. The auditor cannot be expected to be aware of all circumstances which, had the auditor known of them, would have led him/ her to exercise the right to communicate under section 42A of the MPFSO. This section does not require the auditor to change the scope of the audit or other work for the client, nor the frequency or timing of the visits. The auditor has no obligation to seek out grounds for making a report under section 42A of the MPFSO. The section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover a matter upon which the MPFA may need to act. It is only when the auditor does become aware in the ordinary course of the work of such a matter, or of circumstances which suggest the existence of such a matter, that the auditor would consider using the protection of section 42A of the MPFSO.
160. The MPFA recognises that it would not be appropriate for the auditor to report information which the auditor has obtained or matters which the auditor has identified through the professional relationship with another client, even though the information obtained or the matters identified may relate to a trustee or a scheme. However, the MPFA expects the trustee to advise its auditor when it appoints a third party (including another department of the same firm) to review, investigate or report on any aspects of its records and systems and to provide the auditor with copies of reports by such a third party promptly after their receipt. The auditor can, if appropriate, make enquiries in the capacity as the auditor to ascertain whether any findings of the reports should be reported to the MPFA.
161. It should be noted that section 42A of the MPFSO will not provide protection to the auditor where the auditor could be held to have acted maliciously or in bad faith or if the information reported is outside the scope of that section. The MPFSO does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently

affected, by the auditor's action in reporting to the MPFA. The auditor would consider taking legal or other professional advice before making the decision about whether, or in what manner, to report and in order, for example, to ensure that the form and content of the auditor's report are such as to secure the protection of section 42A of the MPFSO and that it only includes relevant material.

162. The auditor is protected, however, even if the information which the auditor communicates fall short of proof, or the opinion which the auditor communicates cannot be verified. An auditor who can demonstrate that he/ she has acted reasonably and in good faith in informing the MPFA of a reportable matter would not be held in breach of duty to the 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.
163. Whilst no breach of statutory duty may arise, it should be appreciated that there is no protection given by the MPFSO, if the auditor, after becoming aware of an occurrence, fail to report, promptly, or at all, to the MPFA. Furthermore, it should be recognised that speed of reporting is likely to be important in order to enable the MPFA to protect the interests of scheme members.

MPFA may require certain reports to be prepared by the auditor under section 30 of the MPFSO

164. Under section 30 of the MPFSO, if at any time the MPFA reasonably believes that circumstances exist or have existed which may prejudice the accrued benefits of a member of a scheme, it may require a trustee, by written notice, to arrange for the auditor (who must be approved by the MPFA) to investigate whether such circumstances exist, or have existed, and to investigate any other matter relating to the trustee or the scheme as specified by the MPFA.
165. A copy of the auditor's report on the investigation must be provided to the MPFA and may be published or supplied to a scheme member that the MPFA believes may have been prejudiced.

Rights and duties of the auditor

Offence to obstruct

166. Under section 107 of the General Regulation, it is an offence for the trustee of a scheme or a service provider appointed or engaged:
- a. not to allow the auditor of the scheme access to all accounting records and other records relating to the scheme and to the trustee of the scheme that are in the possession of that trustee or service provider;
 - b. not to give any information or explanation to the auditor as and when reasonably required by the auditor; and
 - c. to obstruct, hinder or delay the auditor in the performance of the auditor's duties or the exercise of the auditor's powers.

Offence to make false or misleading statement

167. A person who, in any document given to the auditor of a scheme, makes a statement that the person knows to be false or misleading in a material respect, or recklessly makes a statement which is false or misleading, commits an offence and is liable on conviction:
- a. to a fine and imprisonment for 12 months on the first occasion on which the person is convicted of the offence; and
 - b. to a fine of HK\$200,000 and to imprisonment for 2 years on each subsequent offence.

Certain statements of the auditor not admissible evidence

168. The following statements made by the auditor are not admissible in evidence in any civil or criminal proceedings against the auditor and they may not be made the grounds of a prosecution or other legal proceeding against the auditor:
- a. a statement made by the auditor in a notice to the MPFA under Part VIII of the General Regulation; or
 - b. a statement made in answer to an inquiry by the MPFA; or
 - c. reasons for the auditor's removal or resignation from office; or
 - d. reasons for not seeking reappointment.

Removal and resignation of the auditor

169. The removal of the auditor by the trustee will take effect if the auditor and the MPFA are notified in writing within 2 working days after the removal.
170. The auditor must write to the MPFA, within 2 working days of receiving the notice from the trustee, giving reasons why, in the auditor's opinion, he/ she was removed from office.
171. The auditor of a scheme may resign from office by giving written notice to the trustee.
172. An auditor who does not wish to be re-appointed for a further period, if the initial appointment was for a specified period, must notify the trustee in writing.
173. Where the auditor determines to resign in the circumstances set out in paragraphs 171 and 172 above, the written notice of this fact to the trustee must be accompanied by:
- a. a statement that, to the best of the auditor's knowledge and belief, there are no circumstances relating to the resignation or decision not to seek reappointment that would prejudicially affect the interests of the scheme members to a material extent; or
 - b. a statement specifying the circumstances giving rise to the resignation or decision not to accept re-appointment.
174. If a statement under paragraph 173(b) above is given to the trustee, a copy of the notice must be given to the MPFA within 2 working days after giving the notice to the trustee.

PART III
ADDITIONAL GUIDANCE RELEVANT TO
THE AUDITOR OF AN ORSO SCHEME

General

175. The reference in this Part to a retirement scheme or scheme means an ORSO scheme.

Appointment of the auditor

176. The ORSO (section 68) requires any statement, report or other document to be prepared by an auditor in respect of a Hong Kong domiciled scheme to be prepared by a Certified Public Accountant (Practising) as defined by section 2 of the Professional Accountants Ordinance.

177. For an offshore scheme, they must be prepared by a Certified Public Accountant (Practising) or any person who may lawfully practise as a professional accountant in the country or jurisdiction which is the domicile of the scheme and who holds such qualification as the MPFA may accept as being of a standard comparable to that of a Certified Public Accountant (Practising).

Reporting under section 20 of the ORSO

178. The ORSO (section 20) requires the administrator of a scheme to submit the financial statements of the scheme to an auditor annually, for the purpose of independent audit. With few exceptions (see section 20(5) of the ORSO), all schemes, regardless of size or type must be audited. A copy of the audited financial statements of the scheme is required to be submitted by the administrator to the MPFA within 6 months after the end of the scheme's financial period.

179. The first audit would be required in respect of the first financial period ending after the scheme is registered.

Specific audit areas

Investments

180. Section 27 of the ORSO sets out the investment requirement for an ORSO scheme. Section 27(2) imposes the following requirements in respect of investment of scheme assets:

- a. not more than 10% of the assets of the scheme shall consist of restricted investments;
- b. no assets of the scheme shall consist of a loan to the relevant employer of the scheme or an associate of the relevant employer;
- c. subject to subsection (3), no asset of the scheme acquired on or after 15 October 1993 shall consist of investments in the share capital of a body corporate which share capital is not –
 - i. listed on a recognized stock market as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance; or
 - ii. publicly listed on a specified stock exchange as defined in that section.

For further details of the requirements, the auditor is required to refer to section 27 of the ORSO.

181. The auditor would need to perform such procedures as are considered necessary in order to obtain sufficient appropriate audit evidence to enable the auditor to report as to whether or not the requirements of section 27(2) of the ORSO in respect of investment restrictions have been complied with as regards the scheme as at the last day of the year and two other dates in the year as the auditor may elect, provided that the intervening period between all such dates shall not be shorter than three months. Where a scheme has been in operation for less than a full year and the requirements of section 27(2) cannot be satisfied in full, it is recommended that the auditor would select three dates which may not necessarily be three months apart. In planning and performing this work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.

Contributions

182. The ORSO (section 20) also requires the auditor to include a statement as to whether or not, in the auditor's opinion, contributions payable to the scheme during the financial year have been paid in accordance with the scheme rules or the relevant undertaking under which they were payable.
183. The wording of the opinion on contributions is more specific than the opinion required on the financial statements. It requires the auditor to consider the amounts of contributions payable to the scheme and, where the trust deed or rules are specific, the dates of payment.
184. It may be necessary for the auditor to consider whether the results of audit tests or evidence on contributions require a qualified opinion to be given on contributions. Matters to be considered in this respect include the opinion in Form A issued by the employer's auditor (paragraphs 196 - 215 below) and whether any discrepancies favour one particular member or group of members and the extent to which the growth of the fund has suffered because of a failure to pay contributions to the scheme in a proper manner.
185. The auditor may, for example, in the case of a scheme having several participating employers, be unable to obtain sufficient evidence on contributions to give an unqualified opinion. The scope of the examination might be expressly stated as being limited to the transactions as recorded in the books of the scheme.
186. Section 27(2) of the ORSO prohibits loans from the scheme to the employer. Where contributions are outstanding these may, under some circumstances, become de facto loans.

Accrued benefits

187. The financial statements of a retirement scheme are required to disclose:
- a. the liability of the scheme in respect of the benefits which have accrued to members and beneficiaries as a result of their membership of the scheme up to the financial year end of the scheme (aggregate past service liabilities); and
 - b. the benefits to which members would have been entitled in the event that they had resigned from membership of the scheme as at the financial year end date (aggregated vested liabilities). These liabilities are calculated differently depending upon the type of the retirement scheme and therefore the auditing procedures vary.
188. The aggregate past service liability to members and beneficiaries of a defined contribution scheme is the accumulated contributions and allocated net earnings of the scheme. This is normally equivalent to the difference between the carrying amounts of the assets and the other liabilities (including forfeitures available to the employer by way of offset against future contributions or cash refund) of the scheme as at the financial year end date, less any reserves or other net earnings which have not been allocated for the benefit of members. This is normally the amount shown as the total balances of the members' accounts.

189. The aggregate past service liability for defined benefit schemes is the present value of the portion of expected future benefit payments which arise from membership of the scheme up to the financial year end.
190. The amount of the liability depends upon an actuarial review which makes reference to the scheme rules and assumptions such as expected future salary levels, mortality rates and membership turnover.
191. The gross liability is discounted to its present value by applying a discount rate consistent with the rate of return that the scheme would anticipate that it could achieve if, at the financial year end date, sufficient funds were available to meet accrued benefits as they fall due.
192. The procedures appropriate to this aspect of the audit usually include the review of the work of the actuary, which is discussed in paragraphs 25 to 41 above.
193. The aggregate vested liability of a defined contribution scheme is the accumulation of the members' contributions plus the appropriate proportion of the employer's contributions determined by the governing rules of the scheme and the net earnings of the scheme allocated on both balances as at the financial year end date. The aggregate vested liability of a defined benefit scheme is determined by the governing rules of the scheme and is generally calculated by the actuary on the basis of length of service and the salaries of the members as at the financial year end date.

The auditor's reports

194. Section 20 of the ORSO requires:
- a. the auditor's report in relation to the financial statements of a scheme and a financial year of it to state:
 - i. whether or not in the auditor's opinion the financial statements give a true and fair view of the disposition, at the last day of the year, of the scheme assets and liabilities and of its financial transactions for the year then ended;
 - ii. where:
 - the auditor has been denied access to the employer's books and records in contravention of section 20(7) of the ORSO; or
 - the auditor has not been given necessary information and explanations as required by section 20(7) of the ORSO,
 such fact; and
 - iii. such other information as the MPFA may specify in guidelines issued by it; and
 - b. the auditor's report on a scheme's compliance with certain requirements of the ORSO to state whether or not in the auditor's opinion:
 - i. proper accounts and records have been kept as regards all assets, liabilities and financial transactions of the scheme;
 - ii. where the scheme is a defined benefit scheme, the relevant undertaking has been complied with;
 - iii. where the scheme is a defined contribution scheme,
 - contributions have been made in accordance with the terms of the scheme; and

- a shortfall between the scheme's assets and the scheme's aggregate vested liability exists, and if so stating the amount of such shortfall at the last day of the year;
- iv. as at the end of the year the assets of the scheme were subject to any assignment, charge, pledge or other encumbrance except:
- the trust (if any) governing the scheme;
 - any charge or pledge created for the purposes of securing loans necessary for meeting the liabilities of the scheme; and
 - any option to acquire for valuable consideration any interest in the assets of the scheme granted in the normal course of business; and
- v. the requirements of section 27(2) of the ORSO in respect of investment restrictions have been complied with as regards the scheme as at the last day of the year and two such other dates in the year as the auditor may elect, provided that the intervening period between such dates shall not be shorter than three months.
195. The auditor's reports are addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's reports would be addressed to the administrator. Example auditor's reports are included in Appendix 1 to this Practice Note (examples 7 and 8).

Responsibility and scope of work of the employer's auditor under section 20(7A) of the ORSO

196. The ORSO (section 20(7A)) requires the relevant employer to appoint an auditor ("the employer's auditor") who provides confirmation to the administrator's auditor not later than four months after the scheme's financial year end on such matters as may be reasonably required in order for the administrator's auditor to discharge his obligations. The ORSO defines "the administrator's auditor" as being the auditor who is forming the opinion on the scheme's financial statements. The employer's auditor does not need to be the same as the administrator's auditor. Separate engagement letters are required for the appointments of the employer's auditor and the administrator's auditor, whether or not they are the same firm.
197. The role of the employer's auditor is to report under "Forms A and B" as issued by the Registrar under section 20(7A) of the ORSO. Form A is the employer's auditor's statement issued to the administrator's auditor, and Form B is the statement on details of contributions. The employer's auditor is advised to refer to the Guidelines issued by the Registrar on the preparation of the Statement of the Employer's Auditor under section 20(7A) of the ORSO ("Registrar's Guidelines") for guidance.
198. The primary responsibility for completing Form B lies with the employer although in practice it is often completed by the administrator or with assistance from the administrator. Therefore, the employer's auditor would allow the employer to make amendments on the Form B prepared by the administrator if the information contained therein is not correct. Before carrying out any work on Form B, the employer's auditor would ensure that Form B is signed by the employer, or where Form B is signed by the administrator, that it is counter-signed by the employer.
199. The responsibility of the employer's auditor is to complete Form A which is addressed to the administrator's auditor and includes an opinion as to whether proper accounts and records have been kept in relation to contributions and whether Form B is in accordance with the books and records of the employer.

200. As the employer's auditor's work in relation to Forms A and B is usually not within the scope of a normal statutory audit of the financial statements of the employer, the employer's auditor would agree the terms of this engagement in writing with the employer.
201. Where the employer's auditor is not the statutory auditor for the annual audit of the financial statements of the employer, under paragraph 440.10 of the Code of Ethics for Professional Accountants under section 440 "Changes in a professional appointment", the employer's auditor is required to notify the statutory auditor of the work he is undertaking. This notification need not be given if the client advances a valid reason against it. The employer's auditor has the right to expect full co-operation of the statutory auditor in carrying out his assignment.
202. For a scheme that covers more than one relevant employer, the employer's auditor would set out in the engagement letter which relevant employers' Form B will be examined by him.

Procedures performed by the employer's auditor

203. The objective of the employer's auditor giving such an opinion in Form A is to provide the administrator's auditor with reliable audit evidence regarding contributions paid and payable for the financial year of the scheme.
204. The administrator's auditor is responsible for expressing an opinion on the financial statements of the scheme. Among other things, the administrator's auditor is required to report whether proper accounts and records have been kept; whether contributions have been made in accordance with the terms of the scheme and; for defined benefit schemes, whether the relevant undertaking has been complied with in respect of the financial year of the scheme.
205. It is therefore important that the employer's auditor plans and performs appropriate and sufficient procedures on Form B to justify his opinion given in Form A. This opinion provides an important part of the audit evidence required by the administrator's auditor in forming his opinion on the financial statements of the scheme.
206. In considering the nature and extent of procedures necessary, the employer's auditor would have regard to a number of factors, including:
- a. whether the financial year end of the scheme is the same as the financial year end of the employer;
 - b. whether the financial statements of the employer have been or are required to be audited;
 - c. whether the auditor's report on the employer's financial statements was qualified or unqualified;
 - d. the extent and nature of audit work performed on payroll and personnel records during the financial statement audit of the employer and the results of such audit work; and
 - e. the employer's auditor's general knowledge of the employer's business, internal controls and reliability of records.
207. Where the scheme is a defined benefit scheme, the employer's auditor would also have regard to the latest actuarial certificate and funding recommendations for the scheme as well as the "relevant undertaking" made by the employer to contribute to the scheme's funds in accordance with the actuary's recommendations. In such circumstances, the employer's auditor would pay particular attention to the column on Form B headed "percentage of payroll" under "Ordinary contributions from relevant employer".

Dates of receipt and payment of contributions

208. Where the date of receipt of a contribution by the administrator as shown on Form B differs by more than 14 calendar days from the date of payment as recorded in the employer's records, paragraph 23 of the Registrar's Guidelines requires that the opinion in Form A should be qualified in this respect and details of such differences should be provided in Form A.
209. The primary purpose of this qualification of opinion is to alert the administrator's auditor to the possibility of errors or irregularities arising which result in undue delay of contributions being credited to the scheme for the benefit of members. In determining what represents the "date of payment as recorded in the employer's records", the employer's auditor would have regard to the accounting system of the employer. The appropriate date may be determined from different records of the employer, depending upon the accounting system, but should usually represent the date of the cheque or other form of payment made by the employer in respect of the payment of contributions to the administrator.
210. For a scheme which the members or a class of members and their employers are exempted under section 5 of the MPFSO, the employer must pay all contributions to the scheme in respect of a "relevant" period by the due date. The term "relevant period" means each period in respect of which contributions are required to be paid. The due date by which employer contributions are required to have been paid to the scheme is:
- a. if the contribution requirements of a relevant scheme have specified the date on which the relevant employer is to pay a contribution, the due date for that contribution shall be the date so specified.
 - b. if the contribution requirements of a relevant scheme have not specified the date on which the relevant employer is to pay a contribution, the due date for the contribution for each relevant period shall be:
 - i. a day within a month next following the expiration of the relevant period as specified in a statement sent by the employer to the designated person; or
 - ii. if not so specified, the tenth day after the relevant period.

Such required date of payment should not be confused with the payroll date, although in some cases the contribution payment may be tied to the payroll date.

211. Where an employer fails to comply with its obligation to pay contributions by the due date the administrator is obliged to issue a written notice to the employer requiring the employer to pay the outstanding contributions within 30 days of the date of the notice. Such notice must be sent to the employer as soon as practicable after the administrator becomes aware of the failure by the employer to pay contributions by the due date.
212. Where the employer, despite the reminder from the administrator, still fails to pay the contributions which are in arrears the administrator is then obliged to notify the MPFA which, in turn, has the power to issue various payment notices to the employer and impose surcharges and financial penalties on the employer.

Opinion by the employer's auditor (Form A)

213. The employer's auditor is required to express his opinion in the general format set out in Form A. It is important that in expressing his opinion on whether proper accounts and records have been kept in relation to contributions, the employer's auditor indicates clearly whether or not the opinion is qualified, and if it is, precisely what the qualification(s) relate to. Similarly, in expressing his opinion on whether Form B is in accordance with the books and records of the relevant employer, the employer's auditor indicates whether or not the opinion is qualified, and if it is, the details of the exceptions identified. The employer's auditor would need to exercise professional judgement in deciding whether to include all or merely material exceptions identified by him in Form A.

214. The employer's auditor may find it desirable to reproduce Form A on the auditor's own letterheads. This is in order, provided that the contents of Form A conform to those specified in the Registrar's Guidelines. The template of Form A is included in Appendix 2 to this PN.
215. The employer's auditor's work on Form B is essentially an extension of a payroll audit. Therefore in forming an opinion in Form A in respect of whether proper accounts and records have been kept in relation to contributions, the employer's auditor considers whether the payroll and contribution details stated in Form B agree to the books kept by the employer. In addition, the employer's auditor considers whether sufficient personnel records have been kept in respect of each employee. Such personnel records may include the name of the employee, employment letter or contract, age, salary history, date of commencement of employment and date of joining the scheme, etc.

MPFA may require certain reports to be prepared by the auditor under section 32 of the ORSO

216. Under section 32 of the ORSO, the MPFA may under certain conditions require the administrator to cause an auditor approved by the MPFA to prepare a report on any matters specified in a written notice from the MPFA, and to supply the report to the MPFA. Such additional reports would constitute a separate appointment from that as the auditor of the financial statements of the scheme. Accordingly, any auditor appointed under these circumstances would agree the terms of this engagement in writing with the administrator.

APPENDIX 1

Example 1 - auditor's report on the financial statements of a MPF scheme - unqualified opinion

INDEPENDENT AUDITOR'S REPORT³ TO THE TRUSTEE OF XYZ SCHEME

Report on the Financial Statements

We have audited the financial statements of XYZ Scheme ("the Scheme") set out on pages to, which comprise the statement of net assets available for benefits as at [*year end date*], and the statement of changes in net assets available for benefits and [cash flow statement][statement of cash flows]⁴ for the year then ended, and a summary of significant accounting policies and other explanatory information.

Trustee's Responsibility for the Financial Statements

The trustee is 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 is responsible for ensuring that the financial statements have been properly prepared in accordance with sections 80, 81, 83 and 84 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), and for such internal control as the trustee determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit⁵. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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. In addition, we are required to assess whether the financial statements of the Scheme have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 and 84 of the General Regulation.

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 Scheme'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 Scheme's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the trustee, 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.

³ The auditor's report may be tailored to include reporting for constituent funds of the Scheme.

⁴ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

⁵ 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".

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Scheme as at *[year end date]*, and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

Report on matters under the Mandatory Provident Fund Schemes (General) Regulation

- a. In our opinion, the financial statements have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 and 84 of the General Regulation.
- b. We have obtained all the information and explanations which, to the best of our knowledge and belief, are necessary for the purpose of our audit.

ABC & Co.

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

[Auditor's address]

Date of the auditor's report

**Example 2 - auditor's report on a MPF scheme's
compliance with certain requirements of the
Mandatory Provident Fund Schemes Ordinance and the
Mandatory Provident Fund Schemes (General) Regulation
- unqualified conclusion**

COMPLIANCE REPORT BY THE AUDITOR TO THE TRUSTEE OF XYZ SCHEME

We have audited the financial statements of XYZ Scheme ("the Scheme") for the year ended [*year end date*] in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated [*insert date here*].

Pursuant to section 102 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we are required to report whether the Scheme complied with certain requirements of the Mandatory Provident Fund Schemes Ordinance ("MPFSO") and the General Regulation.

Trustee's Responsibility

The General Regulation requires the trustee to ensure that:

- a. proper accounting and other records are kept in respect of the constituent funds of the Scheme, the Scheme assets and all financial transactions entered into in relation to the Scheme;
- b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation are complied with; and
- c. the Scheme assets are not subject to any encumbrance, otherwise than as permitted by the General Regulation.

Auditor's Responsibility

It is our responsibility to report on the Scheme's compliance with the above requirements based on the results of the procedures performed by us.⁶

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Scheme's compliance with the above requirements.

⁶ 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".

Conclusion

Based on the foregoing:

1. in our opinion:
 - a. proper accounting and other records have been kept during the year ended *[year end date]* in respect of the constituent funds of the Scheme, the Scheme assets and all financial transactions entered into in relation to the Scheme; and
 - b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with, in all material respects, as at *[year end date]*, *[.....]*⁺ and *[.....]*^{*}; and
2. as at *[year end date]*, the Scheme assets were not subject to any encumbrance, otherwise than as permitted by the General Regulation.

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

* *insert 2 other dates in the year selected by the auditor for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than 3 months.*

**Example 3 - auditor's report on an applicant trustee's compliance
with prescribed capital adequacy requirements
pursuant to section 18 of the Mandatory Provident
Fund Schemes (General) Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO THE DIRECTORS OF XYZ LIMITED ("the Company")
PURSUANT TO SECTION 18 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 18 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to report on the Company's compliance with prescribed capital adequacy requirements.

Directors' Responsibility

Under the General Regulation, the directors are responsible for the Company's compliance with prescribed capital adequacy requirements.

Auditor's Responsibility

It is our responsibility to report on the Company's compliance based on the results of the procedures performed by us.⁷

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 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on the Company's compliance with prescribed capital adequacy requirements.

Conclusion

Based on the foregoing, in our opinion the Company has complied, in all material respects, with prescribed capital adequacy requirements as set out in section 11[(2)/(3)] of the General Regulation as at *[insert date here]*.

Use of this report

This report is intended solely for submission by the Company to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

⁷ 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 date agreed between the Company and the Mandatory Provident Fund Schemes Authority.*

**Example 4 - auditor's report on the trustee's compliance
with prescribed capital adequacy requirements
pursuant to section 115 of the Mandatory Provident
Fund Schemes (General) Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO XYZ TRUSTEE ("the Trustee")
PURSUANT TO SECTION 115 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 115 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to report on the Trustee's compliance with prescribed capital adequacy requirements.

Management's Responsibility

Under the General Regulation, management is responsible for the Trustee's compliance with prescribed capital adequacy requirements.

Auditor's Responsibility

It is our responsibility to report on the Trustee's compliance based on the results of the procedures performed by us.⁸

Basis of conclusion

We have audited the financial statements of the Trustee for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated *[insert date here]*.

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such additional procedures as we considered necessary for the purpose of reporting on the Trustee's compliance with prescribed capital adequacy requirements.

Conclusion

Based on the foregoing, in our opinion the Trustee has complied, in all material respects, with prescribed capital adequacy requirements as set out in section 11[(2)/(3)] of the General Regulation as at *[year end date]*, *[.....]* and *[.....]* *.

⁸ 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".

* *insert 2 other dates in the year selected by the auditor for performing procedures on checking compliance and such selected dates must be at least 3 months apart or such a shorter period the MPFA may allow.*

Note: In practice, section 115 (5) of the General Regulation imposes a six month deadline for the submission of this report to the trustee in order that the trustee can comply with section 114 (1) of the General Regulation - submission of the trustee's and auditor's report to the MPFA.

Use of this report

This report is intended solely for submission by the Trustee to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Date *[see note below]*

Example 5 - report by the auditor of a service provider for submission to the trustee pursuant to section 74(5)(b) of the Mandatory Provident Fund Schemes (General) Regulation

**INDEPENDENT AUDITOR'S REPORT
TO THE DIRECTORS OF XYZ LIMITED
PURSUANT TO SECTION 74(5)(b) OF THE MANDATORY PROVIDENT FUND SCHEMES
(GENERAL) REGULATION**

Pursuant to section 74(5)(b) of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to issue a report, in respect of the Service Agreements made between XYZ Limited ("the Company") and ABC Trustee dated *[insert date here]* ("Service Agreements").

Directors' Responsibility

Under the General Regulation, ABC Trustee requires the Company to submit to it a report of any material event and an annual report that complies with section 74(5) of the General Regulation. The directors of the Company are responsible for complying with the requirement of ABC Trustee in submitting the abovementioned reports to it.

Auditor's Responsibility

It is our responsibility to issue a report stating whether or not, in our normal course of duties as the auditor of the Company⁹, we have become aware of:

1. any failure of the Company to comply with the Company's obligations under the Service Agreements; and
2. any false declaration made by the Company to ABC Trustee or any other person.

Basis of conclusion

We have audited the financial statements of the Company for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("the HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated *[insert date here]*. The objective of the audit of the financial statements of the Company is to enable us to express an opinion on whether such financial statements give a true and fair view of the financial position of the Company as at *[year end date]* and of its financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

In preparing this report, we have also considered the guidance contained in Practice Note 860.1 "The Audit of Retirement Schemes" issued by the HKICPA.

In relation to our conclusion below, we are not required to perform any procedures in addition to the normal course of audit to search for instances of non compliance with obligations under the Service Agreements or any false declarations made to ABC Trustee or any other person.

⁹ 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".

Conclusion

Based on the foregoing, nothing has come to our attention during the course of our audit of the financial statements of the Company for the year ended *[year end date]* that causes us to believe that the Company:

1. failed to comply with its obligations under the Service Agreements; and
2. made any false declaration to ABC Trustee or any other person.

Use of this report

This report is intended solely for submission by the Company to ABC Trustee as required under section 74(1) of the General Regulation and is not intended to be, and should not be, used by anyone for any other purpose.

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

**Example 6 - auditor's report on the review of the trustee's report on
control objectives and internal control measures
pursuant to section 113 of the Mandatory Provident Fund Schemes (General)
Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO XYZ TRUSTEE
PURSUANT TO SECTION 113 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 113 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to review a report on control objectives and internal control measures dated *[insert date here]* ("Trustee's Report") which is required to be prepared by you as trustee under section 112 of the General Regulation.

Scope

This report covers our review of the Trustee's Report on the control objectives and internal control measures of XYZ Trustee applicable to the approved Mandatory Provident Fund Schemes for which the trustee is XYZ Trustee ("the Schemes"), and does not extend to any other control objectives or internal control measures of XYZ Trustee.

Trustee's Responsibility

Under the General Regulation, XYZ Trustee is responsible for:

1. ensuring that control objectives, as stated under section 39 of the General Regulation, are established and maintained with respect to the Schemes by ensuring that:
 - a. the assets of the Schemes are safeguarded in the interests of members of the Schemes;
 - b. the guidelines made by the Mandatory Provident Fund Schemes Authority ("MPFA") under section 28 of the Mandatory Provident Fund Schemes Ordinance with respect to forbidden investment practices are not contravened;
 - c. the limitations and prohibitions imposed under the General Regulation with respect to the investment of the funds of the Schemes in restricted investments are complied with;
 - d. the requirements of section 37(2) of the General Regulation with respect to capital preservation fund, section 51 of the General Regulation with respect to repurchase agreements, section 52 of the General Regulation with respect to stock lending and Schedule 1 to the General Regulation with respect to permissible investments are complied with in relation to the Schemes; and
 - e. the funds of the Schemes and the assets of the Schemes are, except as permitted by the General Regulation, kept separate from those of the participating employers, XYZ Trustee and the service providers and other persons appointed or engaged for the purposes of the Schemes;
2. establishing and maintaining the following internal control measures and procedures for achieving the above control objectives:
 - a. monitoring investments to ensure that the control objectives referred to in paragraphs 1(b), (c) and (d) above are achieved;
 - b. monitoring the funds of the Schemes and the assets of the Schemes to ensure the objective referred to in paragraph 1(e) above is achieved, so that the funds of the

Schemes and the assets of the Schemes are kept separate from those of the participating employers, XYZ Trustee and any other persons (such as service providers); and

- c. ensuring the accuracy of statements, returns and reports required to be lodged with the MPFA; and
3. implementing the recommended measures outlined in the MPFA Guidelines II.6 "Guidelines on Internal Control Report for each Registered Scheme" ("MPFA Guidelines II.6").

Auditor's Responsibility

It is our responsibility to review the Trustee's Report and report in writing to XYZ Trustee on the review.¹⁰

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 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants. Our work was based upon obtaining an understanding of the control procedures in operation by enquiry of management and review of documents supplied to us.

In accordance with the MPFA Guidelines II.6, we are not required to test and ascertain whether the control objectives and internal control measures as described on pages [] to [] were actually implemented during the year ended *[year end date]*. Our work was limited to ensuring whether relevant control objectives and internal control measures were designed by XYZ Trustee for meeting each of the requirements specified in the General Regulation and the MPFA Guidelines II.6.

We have not performed an assessment of the adequacy or completeness of the control objectives in relation to the risks they are designed to address. Our work was limited to the objectives specified in the General Regulation and our conclusion relates solely to reporting that XYZ Trustee has designed control objectives and internal control measures in line with those recommended in the MPFA Guidelines II.6.

Inherent limitations

Internal control measures 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:

1. appropriate control objectives were established and maintained for the Schemes during the year ended *[year end date]*;
2. effective internal control measures were established and maintained for the purpose of achieving those objectives during the year ended *[year end date]*; and
3. those internal control measures were likely to have been sufficiently effective, in all material respects, to provide a reasonable assurance that the control objectives established and maintained for the Schemes would be achieved if those measures were fully and properly implemented.

¹⁰ 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".

During the course of our engagement, we did not become aware of any shortcomings in the internal control measures that could materially affect the operation of the Schemes (including their financial position) or the financial interests of members of the Schemes during the year ended *[year end date]*.

OR

During the course of our engagement, we became aware of the following shortcomings in the internal control measures that could materially affect the operation of the Schemes (including their financial position) or the financial interests of members of the Schemes during the year ended *[year end date]*:

-
-
-
-
-

Use of this report

This report is intended solely for submission by XYZ Trustee to the MPFA pursuant to section 112(3) of the General Regulation, and is not intended to be, and should not be, used by anyone for any other purpose.

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

**Example 7 - auditor's report on the
financial statements of an ORSO scheme - unqualified opinion**

**INDEPENDENT AUDITOR'S REPORT
TO THE ADMINISTRATOR¹¹ OF XYZ SCHEME**

[Report on the Financial Statements]¹²

We have audited the financial statements of XYZ Scheme ("the Scheme") set out on pages to, which comprise the statement of net assets available for benefits as at *[year end date]*, and the statement of changes in net assets available for benefits and *[cash flow statement]**[statement of cash flows]*¹³ for the year then ended, and a summary of significant accounting policies and other explanatory information.

Administrator's Responsibility for the Financial Statements

The administrator is 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 provisions of the Occupational Retirement Schemes Ordinance, and for such internal control as the administrator determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit¹⁴. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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.

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 Scheme'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 Scheme's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the administrator, 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.

¹¹ The term "administrator" is used in this Practice Note to refer to the trustee if an ORSO scheme is governed by a trust or the insurer if an ORSO scheme is the subject of or regulated by an insurance arrangement. The auditor's report is addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's report is addressed to the administrator.

¹² The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹³ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

¹⁴ 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".

Opinion

In our opinion, the financial statements give a true and fair view of the disposition of the assets and liabilities of the Scheme as at *[year end date]* and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

[Report on matters under section 20(3)(c) of the Hong Kong Occupational Retirement Schemes Ordinance]¹²

[The auditor shall state in the auditor's report such other information as the MPFA may specify in the guidelines issued by it. The auditor is required under the ORSO (section 20(3)(c)) to report by exception the following limitations on the scope of the work:

- a. access to the employer's books and records has been denied; or*
- b. the auditor is unable to obtain all the information and explanations which, to the best of the knowledge and belief, are necessary for the purpose of the audit.]*

ABC & Co.

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

[Auditor's address]

Date of Auditor's Report

**Example 8 - auditor's report on an ORSO scheme's
compliance with certain requirements of the
Occupational Retirement Schemes Ordinance - unqualified conclusion**

**COMPLIANCE REPORT BY THE AUDITOR
TO THE ADMINISTRATOR¹⁵ OF XYZ SCHEME**

We have audited the financial statements of XYZ Scheme ("the Scheme") for the year ended [*year end date*] in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated [*insert date here*].

Pursuant to section 20 of the Occupational Retirement Schemes Ordinance ("ORSO"), we are required to report whether the Scheme complied with certain requirements of the ORSO.

Administrator's Responsibility

The ORSO requires the administrator to ensure that:

- a. proper accounts and records are kept as regards all assets, liabilities and financial transactions of the Scheme;

[*For a defined benefit scheme only*]

- b. the relevant undertaking, as defined under section 20(4) of the ORSO¹⁶, is complied with;

OR

[*For a defined contribution scheme only*]

- b. contributions are made in accordance with the terms of the Scheme;
- c. the assets of the Scheme are not subject to any assignment, charge,¹⁷ pledge or other encumbrance except for those specified in section 20(3)(b)(iii) of the ORSO¹⁷; and
- d. the requirements of section 27(2) of the ORSO¹⁸ are complied with.

Auditor's Responsibility

It is our responsibility to report on the Scheme's compliance with the above requirements based on the results of the procedures performed by us.¹⁹

¹⁵ The term "administrator" is used to refer to the trustee if an ORSO scheme is governed by a trust or the insurer if an ORSO scheme is the subject of or regulated by an insurance arrangement. The auditors' report is addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditors' report is addressed to the administrator.

¹⁶ "relevant undertaking" is defined by section 20(4) and Schedule 2 Parts 1 and 2 paragraph 6 of the ORSO as a written undertaking by the relevant employer of the scheme (i.e. the employer who provides the employment which entitles or enables the employee to be a member of the scheme) to the administrator of the scheme to contribute to the scheme's fund in accordance with recommendations made by the actuary in the actuarial certificate issued as regards a particular registered scheme. Where more than one actuarial certificate has been issued, the undertaking referred to is the one in the most recent of those certificate which is applicable to the financial period under review.

¹⁷ *The exceptions stated in section 20(3)(b)(iii) of the ORSO are as follows:*

- a. *the trust (if any) governing the scheme;*
- b. *any charge or pledge created for the purposes of securing loans necessary for meeting the liabilities of the scheme; and*
- c. *any option to acquire for valuable consideration any interest in the assets of the scheme granted in the normal course of business.*

¹⁸ *Section 27(2) of the ORSO stipulates the investment restrictions.*

¹⁹ 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".

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Scheme's compliance with the above requirements.

Conclusion

Based on the foregoing, in our opinion:

1. proper accounts and records have been kept during the year ended *[year end date]* as regards all assets, liabilities and financial transactions of the Scheme;

[For a defined benefit scheme only]

2. the relevant undertaking, as defined under section 20(4) of the ORSO, has been complied with during the year ended *[year end date]*;

OR

[For a defined contribution scheme only]

2. contributions have been made in accordance with the terms of the Scheme during the year ended *[year end date]*; and

[If there is a shortfall]

at *[net assets statement date]* there was a shortfall amounting to HK\$..... between the Scheme's assets and the Scheme's aggregate vested liability;

OR

[If there is no shortfall]

at *[net assets statement date]* there was no shortfall between the Scheme's assets and the Scheme's aggregate vested liability;

3. at *[net assets statement date]* the assets of the Scheme were not subject to any assignment, charge, pledge or other encumbrance except for those specified in section 20(3)(b)(iii) of the ORSO; and

4. at *[net assets statement date]*, *[.....]* and *[.....]*²⁰ the requirements of section 27(2) of the ORSO have been complied with.

Use of this report

This report is intended solely for submission by the administrator to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

²⁰ Insert two other dates in the year selected by the auditors for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than three months.

Example 9 - auditor's report on the financial statements of an APIF - unqualified opinion

INDEPENDENT AUDITOR'S REPORT TO THE [TRUSTEE][INSURER] OF XYZ FUND

Report on the Financial Statements

We have audited the financial statements of XYZ Fund ("the Fund") set out on pages to, which comprise the statement of net assets attributable to [fundholders][unitholders] as at [*year end date*], and the statement of comprehensive income, the statement of changes in net assets attributable to [fundholders][unitholders] and [cash flow statement][statement of cash flows]²¹ for the year then ended, and a summary of significant accounting policies and other explanatory information.

[[Manager's and] [Trustee's] [Insurer's] Responsibility for the Financial Statements

The [Manager and the] [Trustee][Insurer] of the Fund [are][is] 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 are responsible for ensuring that the financial statements have been properly prepared in accordance with the relevant disclosure provisions of the constitutive documents of the Fund ("the Constitutive Documents"), the Mandatory Provident Fund Schemes Ordinance ("the MPFSO"), the Mandatory Provident Fund Schemes (General) Regulation ("the General Regulation"), the Code on MPF Investment Funds ("the MPF Code"), and Guidelines II.5 issued by the Mandatory Provident Fund Schemes Authority ("the MPFA") [and the Code on Unit Trusts and Mutual Funds ("the Code") issued by the Hong Kong Securities and Futures Commission ("the SFC")]²², and for such internal control as the [manager and the] [trustee][insurer] determine[s] is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit²³. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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. We are also required to assess whether the financial statements of the Fund have been properly prepared, in all material respects, in accordance with the relevant disclosure provisions of the constitutive documents of the Fund, the MPFSO, the General Regulation, the MPF Code and Guidelines II.5 issued by the MPFA [and the Code issued by the SFC]²².

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 judgement, 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 Fund'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 Fund's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the [manager and the] [trustee][insurer], as well as evaluating the overall presentation of the financial statements.

²¹ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

²² Delete if the Fund is only approved by the MPFA but not authorized by the SFC under section 104(1) of the Securities and Futures Ordinance.

²³ 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".

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 financial position of the Fund as at *[year end date]*, and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

- (a) In our opinion, the financial statements have been properly prepared, in all material respects, in accordance with the relevant provisions of the constitutive documents of the Fund, the MPFSO, the General Regulation, the MPF Code and Guidelines II.5 issued by the MPFA [and the Code issued by the SFC]²²; and
- (b) We have obtained all the information and explanations which, to the best of our knowledge and belief, are necessary for the purpose of our audit.

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

Example 10 - auditor's report on an APIF's compliance with certain requirements of the Mandatory Provident Fund Schemes Ordinance, the Mandatory Provident Fund Schemes (General) Regulation and the Code on MPF Investment Funds - unqualified conclusion

COMPLIANCE REPORT BY THE AUDITOR TO THE [TRUSTEE][INSURER] OF XYZ FUND

We have audited the financial statements of XYZ Fund ("the Fund") for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued *[an unqualified/a qualified]* auditor's report thereon dated *[insert date here]*.

Pursuant to Guidelines II.5 and Code on MPF Investment Funds issued by the Mandatory Provident Fund Schemes Authority, we are required to report whether the Fund complied with certain requirements of the Mandatory Provident Fund Schemes Ordinance ("the MPFSO") and the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), which are made applicable to the Fund through the Code on MPF Investment Funds.

[Manager and the] [Trustee][Insurer]'s Responsibility

The General Regulation requires the *[manager and the] [trustee][insurer]* to ensure that:

- a. proper accounting and other records are kept in respect of the Fund assets and all financial transactions entered into in relation to the Fund;
- b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority ("the MPFA") under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 of, and Schedule 1 to, the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds, are complied with; and
- c. the Fund assets are not subject to any encumbrance, otherwise than as permitted by section 65 of the General Regulation.

Auditor's Responsibility

It is our responsibility to report on the Fund's compliance with the above requirements based on the results of the procedures performed by us.²⁴

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Fund's compliance with the above requirements.

²⁴ 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".

Conclusion

Based on the foregoing:

1. in our opinion:
 - a. proper accounting and other records have been kept during the year ended *[year end date]* in respect of the Fund assets and all financial transactions entered into in relation to the Fund; and
 - b. the requirements specified in the guidelines made by the MPFA under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 of, and Schedule 1 to, the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds, have been complied with, in all material respects, as at *[year end date]*, *[.....]*^{*} and *[.....]*^{*}.
2. as at *[year end date]*, the assets of the Fund were not subject to any encumbrance, otherwise than as permitted by section 65 of the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds.

Use of this report

This report is intended solely for submission by the [manager and the] [trustee][insurer] to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

* *insert 2 other dates in the year selected by the auditor for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than 3 months.*

APPENDIX 2

FORM - A

Occupational Retirement Schemes Ordinance (Cap. 426)
("the Ordinance")

The Employer's Auditor's Statement to the
Administrator's Auditor under section 20(7A) of the Ordinance

Name of the Relevant Employer: _____
(“the relevant employer”)

Name of the Occupational
Retirement Scheme: _____
(“the Scheme”)

Registration No. of the Scheme: _____

Types of Scheme (indicate by a tick in the appropriate boxes):-

- Defined contribution
- Defined benefit
- Governed by trust
- Subject of or regulated by insurance arrangement
- Participating in a pooling agreement:-
Yes
No

If “Yes”, name of pooling agreement: _____

- Participating in a group scheme
(see Paragraph 10 of Registrar's Guidelines):-
Yes
No

If “Yes”, name of representative employer: _____

Name of employer's auditor: _____

Name of administrator's auditor: _____

Address of administrator's auditor: _____

THE AUDIT OF RETIREMENT SCHEMES

*I/We, _____, of
(name of employer's auditor)

(address of employer's auditor)

being the employer's auditor duly appointed under section 20(7B)(a) of the Ordinance, hereby state as follows:-

1. *I/We have completed procedures on the Statement on Details of Contributions (Form B attached) for the financial year ended _____ in so far as they relate to the Scheme, having regard to the guidelines issued by the Registrar and in accordance with the pronouncements issued by Hong Kong Institute of Certified Public Accountants.
2. Based on these procedures in *my/our opinion:-
 - (a) proper accounts and records *have/have not been kept in relation to contributions; and
 - (b) the Statement on Details of Contributions is in accordance with the books and records of the relevant employer (*except as noted here-under):-

(Signed)
(Name of employer's auditor)

(Date)

(Place)

* Delete whichever is not applicable.

(This Form and the attached Form B should be returned directly to the administrator's auditor.)

PN 860.1 (Revised)
Issued [] 2014 ~~Revised November 2013~~

Effective for financial statements which cover a period
beginning on or after 3 March 2014
Early application is not permitted ~~Effective upon issue~~

Practice Note 860.1 (Revised)

The Audit of Retirement Schemes



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

**PRACTICE NOTE
860.1 (REVISED)
THE AUDIT OF RETIREMENT SCHEMES**

*(Issued [] 2014 February 1999; revised December 2001, September 2004 (name change) and revised November 2013; Effective upon issue Effective for financial statements which cover a period beginning on or after 3 March 2014.
Early application is not permitted)*

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APPENDIX 2 – TEMPLATE OF FORM A UNDER SECTION 20(7A) OF THE ORSO

PRACTICE NOTE
860.1 (REVISED)
THE AUDIT OF RETIREMENT SCHEMES

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 retirement schemes, with particular focus on those registered under the Mandatory Provident Fund Schemes Ordinance (MPFSO) and the Occupational Retirement Schemes Ordinance (ORSO).
2. This Practice Note also provides guidance relevant to the auditor's other reporting responsibilities under the MPFSO and the ORSO:
 - a. the MPFSO
 - i. the auditor's report on compliance with prescribed capital adequacy requirements pursuant to sections 18 and 115 of the Mandatory Provident Fund Schemes (General) Regulation (General Regulation);
 - ii. the auditor's report on a review of the trustee's report on control objectives and internal control measures pursuant to section 113 of the General Regulation; and
 - iii. the report by the auditor of a service provider under section 74(5)(b) of the General Regulation.
 - b. the ORSO
 - i. the report by the auditor appointed by the administrator under section 20(1)(b) and 20(3) of the ORSO; and
 - ii. work of the employer's auditor under section 20(7A) of the ORSO.

Guidance is also provided on the communications between the auditor and the Mandatory Provident Fund Schemes Authority (MPFA).

3. This Practice Note has been prepared in consultation with the MPFA.
4. This Practice Note is based on the ORSO in effect as at 23 July 1999 (i.e. the ORSO as amended by the Occupational Retirement Schemes (Amendment) Ordinance 1999), and the MPFSO and the General Regulation in effect as at 25 April 2013, and guidelines issued by the MPFA up to November 2013. 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.

5. It should be borne in mind that certain expressions used in the MPFSO, the General Regulation and the ORSO 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

6. The definitions used in this Practice Note are:
- a. *Administrator*
The trustee of an ORSO scheme governed by trust or the insurer of an ORSO scheme which is regulated by an insurance arrangement.
 - b. *Aggregate past service liability*
As defined in section 2(1) of the ORSO.
 - c. *Aggregate vested liability*
As defined in section 2(1) of the ORSO.
 - d. *Authorized financial institution*
An institution authorized under Part IV of the Banking Ordinance.
 - e. *Authorized insurer*
An insurer authorized under section 8 of the Insurance Companies Ordinance.
 - f. *Control objectives*
In relation to a MPF scheme, the control objectives for the time being applicable to the scheme maintained under section 39 of the General Regulation.
 - g. *A defined benefit scheme* is one which is not a defined contribution scheme.
 - h. *A defined contribution scheme* is one which provides that amount of a benefit under the scheme is to be an amount determined solely by reference to:
 - i. the contributions to the scheme's funds by or in respect of the member concerned and any declared return in respect of such contributions (where such return may be subject to a minimum guaranteed rate but is otherwise unascertainable before it is declared); and
 - ii. where appropriate, the qualifying service and age of the member (employee).
 - i. *Encumbrance* includes a charge, pledge, lien and mortgage.
 - j. *MPFSO*
Mandatory Provident Fund Schemes Ordinance.
 - k. *General Regulation*
Mandatory Provident Fund Schemes (General) Regulation.
 - l. *Exemption Regulation*
Mandatory Provident Fund Schemes (Exemption) Regulation

- m. *MPF Code*
Code on MPF Investment Funds
- n. *MPFA*
Mandatory Provident Fund Schemes Authority.
- o. *MPF scheme*
A retirement scheme registered under section 21 of the MPFSO as an employer sponsored scheme or a master trust scheme, or section 21A of the MPFSO as an industry scheme.
- p. *ORSO*
Occupational Retirement Schemes Ordinance.
- q. *ORSO scheme*
A retirement scheme registered under the ORSO.
- r. *Pooling arrangement or agreement*
A pooling arrangement or agreement is one where two or more schemes are administered together. Under such an arrangement, a number of individual schemes can participate either through a master trust deed or a master insurance policy depending on whether the pooling arrangement is governed by a trust or is the subject of, or regulated by an insurance agreement. Master trust schemes and industry schemes established under the MPFSO also operate within a pooling arrangement.
- s. *Relevant employer*
An employer who provides the employment which entitles or enables the employee to be a member of a retirement scheme.
- t. *Relevant undertaking*
Relevant undertaking is defined by section 20(4) and Schedule 2 Parts 1 and 2 paragraph 6 of the ORSO as a written undertaking by the relevant employer of the scheme to the administrator of the scheme to contribute to the scheme's fund in accordance with recommendations made by the actuary in the actuarial certificate issued as regards a particular scheme. Where more than one actuarial certificate has been issued, the undertaking referred to is the one in the most recent of those certificates which is applicable to the financial period under review.
- u. *Retirement scheme/scheme*
Any instrument or agreement (other than contracts of life insurance) to provide a benefit, payable on termination of service, death, retirement or otherwise, to a person or his beneficiary as a result of a contract of service of employment, whether in Hong Kong or elsewhere. For the purpose of this Practice Note, this includes self-employed persons.
- v. *Rules*
MPFSO/ ORSO Subsidiary Legislation

w. *Trustee*

Approved trustee of MPF schemes.

Regulatory background

7. Retirement schemes are generally either constituted as trusts or insurance arrangements (policies). Retirement schemes in Hong Kong are required to be registered under the MPFSO or the ORSO, although schemes may apply to the MPFA for an exemption. The MPFA assumes the role as the Registrar of Occupational Retirement Schemes (Registrar) in administering the ORSO with effect from 10 January 2000. Exemption from the ORSO (section 7) is allowed for schemes with not more than 10% or 50 of their members, whichever is less, being Hong Kong permanent identity card holders. In exceptional cases, exemption may also be granted, at the discretion of the MPFA, for offshore schemes which are registered or approved by a recognised overseas authority.
8. The environment in which a retirement scheme operates is different from that of most commercial enterprises. The auditor would need to be familiar with the regulatory background to retirement schemes, in particular the requirements of the MPFSO, the General Regulation, the Exemption Regulation, the ORSO, the relevant Rules, guidelines and codes issued by the MPFA, as appropriate, and the accounting aspects of their operation before commencing the audit.
9. For schemes registered under the MPFSO or the ORSO, the trustee/administrator has various responsibilities imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA. The three main objectives of the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA are regulation, segregation and information.

Administration of a retirement scheme

10. The administration of a retirement scheme involves the input and interaction of a number of different parties:
 - a. the relevant employer - has an on-going responsibility for providing adequate funding to the scheme and ensuring that his obligations under the scheme terms and the relevant legislation are properly discharged;
 - b. the trustee/administrator - is responsible for ensuring that the scheme is administered in accordance with its governing rules/trust deed, and where applicable, the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA;
 - c. the employee (or the member) - has a responsibility for providing contributions to the scheme (in the case of a contributory scheme) and as the ultimate beneficiary of the scheme has a vested interest in ensuring that the scheme is administered properly and is providing appropriate returns on the contributions made;
 - d. the administrator's/trustee's auditor - is responsible for the independent audit of the scheme;
 - e. the employer's auditor - is responsible for examining the relevant records of the employer and preparing the employer's auditor's statement for ORSO schemes (see paragraphs 196 to 215 below); and
 - f. the scheme actuary - is responsible for reviewing the sufficiency of the scheme's assets and preparing the actuarial certificate for defined benefit schemes (see paragraphs 25 to 32 below).

11. While the trustee/administrator is ultimately responsible for the proper operation of a retirement scheme, he may choose to delegate some or all of his management functions to a third party. Where the trustee has delegated any function to a service provider (such as the administration or the investment function), the trustee/administrator must ensure that there are internal control procedures in place to monitor the activities of the service providers. The trustee/administrator must ensure that the service providers have carried out their duties in accordance with the agreements and the trustee/administrator is notified of any material changes relating to the eligibility of the service providers or material breach of obligations by the service providers.

Audit requirements

12. The audit requirements of MPF schemes and ORSO schemes are set out respectively in Parts II and III of this Practice Note below.
13. The auditor ensures that he/ she is familiar with Hong Kong Accounting Standard 26 "Accounting and Reporting by Retirement Benefit Plans" which deals with accounting and reporting by the plan to all participants as a group.

Commentary on the application of Hong Kong Standards on Auditing (HKSA)s

Compliance with HKSA)s

14. HKSA)s apply to the audits 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 is set out in paragraphs 15 to 44 below identifies the special considerations arising from the application of individual HKSA)s to the audits of the financial statements of retirement schemes. Where no special considerations arise from a particular HKSA, no material is included.

Engagement letters

15. The auditor issues engagement letters in accordance with the principles and requirements of HKSA 210 "Agreeing the Terms of Audit Engagements". Specific issues which the auditor would address in engagement letters applicable to retirement schemes include:
- a. the nature and scope of the auditor's reporting responsibilities under the MPFSO/ORSO, the General Regulation, the MPF Code and the relevant guidelines issued by the MPFA;
 - b. the extent of the auditor's rights to obtain information and explanations from the relevant employer and/or persons to whom the trustee/administrator has delegated some or all of his duties;
 - c. the fact that the audit will be planned so that there is a reasonable expectation of detecting material misstatements in the financial statements resulting from breaches of trust or statute. It should be made clear, however, that the audit should not be relied on to detect all breaches which may exist; and
 - d. the extent of the auditor's responsibility for information/documents which may be contained in the documents containing the audited financial statements of the scheme.

Planning

16. The auditor plans the audit in accordance with HKSA 300 "Planning an Audit of Financial Statements". Consideration of specific matters related to retirement schemes may also include:
- a. whether the trustee/administrator has a sound understanding of the legislation and rules governing the scheme as set out under the trust deed, the insurance agreement

and/or the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA;

- b. whether the trustee/administrator has the necessary training and skills required to maintain the records of the scheme (both financial and non-financial), given that the trustee/administrator may have to maintain membership records, make investment decisions and administer benefit payments; and
 - c. whether there is close involvement of the employer in a "directly invested scheme". Direct investment is a term used to describe a method of investment for a scheme by which securities are held directly in the name of the trustees.
17. The operation of a retirement scheme can involve complex technical issues and calculations in areas in which the auditor cannot be expected to be expert. During the course of the audit it may be necessary for the auditor to obtain confirmations from other professional advisers such as actuaries, fund managers and solicitors. The audit planning would therefore include details of the advisers and the extent to which reliance would be placed on information provided by them.

Internal controls

18. The auditor considers internal controls in accordance with HKSA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
19. The trustee/administrator has a duty to maintain adequate accounting records and systems to enable his duties to be carried out including discharging his responsibilities for investment decisions and safeguarding the scheme's assets.
20. The nature and extent of a scheme's accounting systems, procedures and internal controls depend mainly upon the size of the scheme, the extent to which the trustee/administrator delegates the administration of the scheme to third parties and the nature of its investments.
21. Where a trustee/administrator delegates the management of a significant part of the scheme's operations to a third party, the auditor considers the requirements of HKSA 402 "Audit Considerations Relating to an Entity Using a Service Organization". In particular, the auditor would need to assess the systems and controls the trustee/administrator has in place to monitor and control the activities of the third party, and those of the third party itself. This may involve corresponding with the auditor of the third party.
22. Where some or all of the scheme is administered in-house, the size of the scheme and the size of the employer's operations determine the scope for developing internal controls and therefore whether formalised procedures and internal controls for certain transactions exist. For example, in a small scheme the infrequency of particular types of transactions such as benefits payable on the death in service of members, may result in no formal control being in place. It may also be difficult for the trustee/administrator to achieve a proper segregation of duties. In such instances, it is unlikely that the auditor is able to place reliance on those internal controls.

Computer systems

23. The auditor considers the requirements of HKSA 315 and also to the matters set out in paragraph 24 below.
24. The processing and recording of a large number of scheme member records and related transactions frequently involve the use of computer systems. Typical examples of scheme administration functions that are performed by computerised procedures include:
- a. calculation of contributions receivable;

- b. calculation of benefits payments and vested benefits;
- c. generation of computer cheques for benefit payments;
- d. allocation of investment income and expenses; and
- e. scheme accounting function.

Review of actuarial information

General

- 25. The requirement for actuarial reviews only applies to defined benefit schemes. Under a defined contribution scheme the vested benefit (the member's contributions and a proportion of the employer's contributions plus the net investment return on both) is more readily identifiable from the scheme's accounting records.
- 26. Without actuarially determined disclosures in the financial statements of a defined benefit scheme, the financial statements only give limited information about the state of affairs of the scheme. Actuarial reviews are necessary to assess, amongst other things, the ability of the scheme to pay the defined benefits in the future.
- 27. The ORSO (section 31) requires an actuarial review to be performed at least once every three years and the report to be given to the administrator within six months of the date at which the review takes place. However schemes where solvency is an issue require a review every year. The primary purpose of this review is to monitor the solvency and funding of the scheme.
- 28. Accordingly, the full actuarial certificate arising from this review is required by the ORSO (schedule 2) to include the following statements:
 - a. that, in the course of the actuarial review, the actuary has had regard to the financial condition of the scheme;
 - b. that the assets of the scheme were (or, in the case of a qualified certificate, were not) sufficient to meet its aggregate vested liability at the valuation date;
 - c. that, following his review, the actuary has made recommendations as regards funding of the scheme;
 - d. that, following his review, the actuary has received a copy of a written undertaking by the relevant employer of the scheme to the administrator of the scheme that he will contribute to the scheme's funds in accordance with those recommendations; and
 - e. that, provided the scheme is funded in accordance with the actuary's recommendations the actuary would expect that the scheme's assets would be sufficient to meet its aggregate vested liability throughout the next three years, and, at a specified date, they would be sufficient to meet the scheme's aggregate past service liability.
- 29. In the event that a qualified actuarial certificate is issued, the auditor is advised to refer to Part 2 of Schedule 2 to the ORSO (which details information to be given by the actuary).
- 30. In addition to the statutory requirements set out above, actuarial reports can provide an assessment of a defined benefit scheme's progress in achieving its objective of providing members' future benefits. The results of an actuarial review are used to determine the appropriate contribution level and to indicate any surplus or deficiency in the funding of the retirement scheme.

31. A practical way of showing the level of funding of a scheme is for the actuary to indicate the trend in the values of the following from the latest valuation and from previous valuations, if they are available:
- a. the amount of aggregate vested liabilities; and
 - b. the amount of aggregate past service liabilities.

32. The actuary arrives at the actuarial valuation by taking the discounted value of future benefits that are expected to arise in the scheme in respect of members, and comparing this with the value of scheme assets, and the discounted value of future contributions. The actuary would also compare scheme assets with past service liabilities and vested liabilities. In doing so the actuary makes a number of assumptions, including earnings rate, inflation, salary increases and staff turnover rates.

The auditor's responsibilities

33. In considering the work of the actuary as audit evidence, the auditor considers the requirements of HKSA 500 "Audit Evidence" on information produced by a management expert.
34. As set out in paragraph 8 of HKSA 500, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor is required to perform the following procedures:
- a. Evaluate the competence, capabilities and objectivity of that expert;
 - b. Obtain an understanding of the work of that expert; and
 - c. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Further guidance are set out in paragraphs A37 to A48 of HKSA 500. Additional specific considerations which apply in the audit of retirement schemes are set out below in paragraphs 35 to 39 below.

35. In evaluating the work of an actuary, the auditor is required to consider the following:
- a. the source data used;
 - b. the assumptions and methods used and their consistency; and
 - c. the results of the expert's work in the context of the auditor's overall knowledge.
36. The auditor would need to be satisfied as to the accuracy and reasonableness of the source data. The source data used is provided by the administrator and includes information on salaries, date of birth of members, date of joining the employer, date of joining the scheme, contribution rates, accumulation of member and employer contributions, benefit multiples and investments held.
37. The assumptions used comprise both ones which pertain to the scheme and the industry in which the scheme operates and ones which are used by actuaries generally, such as inflation and interest rates.
38. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the actuary. The auditor does not have the same expertise and, therefore, cannot always challenge the actuary's assumptions and methods. However, the auditor seeks to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.

39. The auditor would also consider the consistency of the actuary's assumptions and the funding method used to calculate the members' future benefits. By changing the assumptions and funding method, the valuation changes and this affects the surplus or deficiency in the fund and the required contribution rates. Any such changes in assumptions or funding method should be explained by the actuary. The auditor would also give special attention to the consistency of the margin between the projected returns of the scheme and the projected salary rises. If the results of the actuary's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor would seek to resolve the matter. This may involve discussions with the administrator and the actuary, applying additional procedures, including possibly engaging another actuary.

Deficiency of assets

40. It is not uncommon for some of these calculations to show a deficiency of assets to meet the amount of members' benefits calculated. The auditor would review the actuary's recommendations to determine whether the relevant employer has made contributions to the scheme in accordance with such recommendations. These recommendations may include an increase in the amount of contributions or an extension of the period over which contributions are made.
41. The auditor would need to determine whether a deficiency may imply an inability of the scheme to meet its obligations as and when they fall due. Furthermore, in any year in which an actuarial certificate has not been prepared, the auditor would consider whether economic circumstances have eroded the value of the investments, which might also imply that the scheme may not be able to meet its obligations as and when they fall due. Such uncertainties may give rise to additional disclosure in the financial statements and/or the need to include an explanatory paragraph dealing with a fundamental uncertainty or a qualification in the auditor's report.

Consideration of laws and regulations

42. In accordance with HKSA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor considers the impact of the relevant requirements of the trust deed or scheme rules, the ORSO, the MPFSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA on their audit. As stated in HKSA 250, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The requirements in HKSA 250 are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor's reports

43. The principles set out in HKSA 700 "Forming an Opinion and Reporting on Financial Statements" are applicable to auditor's report on retirement scheme financial statements. For ORSO schemes the auditor's reports are addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's reports would be addressed to the administrator. For MPF schemes the auditor's reports are addressed to the trustee.

Review of trustees' (or administrator's) report/scheme report/investment report

44. The trustees' report, the scheme report and the investment report do not form part of the audited financial statements. However, as they will form part of the same document, the auditor refers to HKSA 720 "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements" concerning the auditor's responsibilities in this area.

Specific audit areas

Investments

General

45. The trustee/administrator is responsible for the process of investing the scheme assets. The trustee/administrator must therefore ensure that investments conform to the requirements of the scheme's rules, restrictions imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA and the general duties and obligations established under trust law.
46. Most schemes allow trustees/administrators a wide range of investment choice. There are however, some restrictions imposed by the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA. Examples of such restrictions in respect of MPF and ORSO schemes are included in Parts II and III of this Practice Note respectively.
47. The audit of investment balances in a retirement scheme is essentially no different to the audit of investment balances in any other organisation, except where the trustee/administrator chooses to delegate the management of the investment portfolio to a third party. The audit implications of this situation are discussed in paragraph 21 above.

Audit objectives

48. The auditor would consider whether:
 - a. the investments of a scheme exist and are owned by the scheme;
 - b. all investments of the scheme have been accurately and completely recorded in the books of the scheme;
 - c. the investment policy of the scheme is in accordance with the terms of the scheme rules/trust deed, the MPFSO/ORSO (where applicable), the General Regulation (where applicable), the Exemption Regulation (where applicable), the relevant Rules, guidelines and codes issued by the MPFA;
 - d. all investments are appropriately valued; and
 - e. all investment balances are appropriately classified and disclosed in the financial statements of the scheme.

Contributions

General

49. There are principally two types of contributions, namely:
 - a. employer financed; and
 - b. member financed.

These two categories can be further subdivided. For example, the employer contribution may take the form of a contribution based on a specified rate (by the MPFSO, trust deed or by the actuary), and member contributions may include contribution based on a specified rate, additional voluntary contribution or amounts rolled over from other schemes.

50. The trustee's/administrator's primary responsibility for contributions is to ensure that all contributions due have been paid over to the scheme on a timely basis, and have been recorded to the members' benefit completely and accurately. Specific responsibilities of the trustee/administrator for contributions are included in Parts II and III of this Practice Note below.
51. In fulfilling this responsibility the trustee/administrator must firstly ensure that all new members have been properly admitted to the scheme in accordance with the provisions of the governing rules or trust deed, members who have ceased their membership during the year have been appropriately removed from the membership register, and that details relating to all continuing members are properly carried forward in the scheme records. The trustee/administrator must ensure that all membership records are accurate.
52. The trustee/administrator is required to ensure that both employer and member contributions are made in accordance with the governing rules or other relevant agreements and as recommended by the actuary (in the case of a defined benefit scheme) and such contributions are made on a timely basis.

Audit objectives

53. The auditor would consider whether:
 - a. all contributions receivable from, or on behalf of, eligible members have been received and have been recorded in the correct period; and
 - b. contributions received have been made in accordance with the governing rules or other relevant agreements and, for defined benefit schemes, the recommendations of the actuary.

Specific risk areas

54. The main risks are those of completeness and accuracy. Completeness involves ensuring that all contributions are recorded, either as received or receivable. Accurate calculation is particularly relevant to defined contribution schemes where employer's contributions are based on a percentage of a member's salary. The auditor would also consider whether contributions receivable are recoverable, particularly if the employer has a significant level of contributions owing at the financial year end of the scheme.

Benefits

General

55. Benefits are normally paid by way of a lump sum. The amount and means of calculation of the benefit paid depend on the type of the scheme.
56. Where a scheme is a defined contribution scheme, the benefit paid will equal the members' vested benefit in the scheme which is the accumulation of the members' contributions plus the appropriate proportion of the employer's contributions and the investment return on both.
57. Where the scheme is a defined benefit scheme, the benefit paid is determined by the governing rules and is generally calculated on the basis of length of service and the members' salary, which may be based on current salary, an average salary or another method as determined by the scheme rules.
58. The trustee/administrator is primarily responsible for ensuring that all benefit payments which should have been made are correctly paid to bona fide members in accordance with the governing rules or the MPFSO/ORSO, the General Regulation, the Exemption Regulation, the relevant Rules, guidelines and codes issued by the MPFA.

59. In many cases, where an employee leaves an ORSO scheme, part or all of the employer's contributions plus the investment returns thereon in respect of that member may not be paid to the member. These forfeitures may be applied (depending on the rules of the scheme) in reducing the contributions of the employer, retained in the scheme for the benefit of members, or returned to the employer. The same rules will apply to voluntary contributions made by an employer to a MPF scheme.

Audit objectives

60. The auditor would consider whether:
- a. benefits paid and payable are bona fide, have been correctly calculated and have been recorded in the correct period; and
 - b. benefits have been paid in accordance with the scheme rules/trust deed and the MPFSO/ORSO, the Exemption Regulation (where applicable), the relevant Rules, guidelines and codes issued by the MPFA.

Specific risk areas

61. The principal audit risks in relation to benefits are those of completeness and accuracy. Completeness involves ensuring that all benefits are recorded either as paid or payable. Calculation of benefits paid is relevant, particularly with respect to defined benefit schemes, and benefits are paid to people who are not entitled to receive them.

Pooling arrangements

General

62. The ORSO (section 2(4)) permits pooling arrangements to be governed by a trust, provided that it is managed by a registered trust company. All MPF schemes must be governed by trust. The master trust deed sets out, amongst other things, the respective powers and duties of the pool trustee and the administrator. The ORSO (section 2(4)) also permits pooling arrangements to be the subject of or regulated by an insurance agreement (policy). This master policy sets out the respective powers and duties of the administrator, usually the insurer, and the relevant employer.
63. The ORSO (section 2(4)) requires that proper accounts and records are kept with respect to the pooling arrangement and its participating schemes, such that the value of the assets attributable to, and the liabilities of, each of its participating schemes are readily determinable. The General Regulation (section 78) requires that a separate account is established and maintained for each scheme member specifying that member's accrued benefits.
64. Where a scheme is a participating scheme in a pooling agreement, section 21(4A) of the ORSO provides that the asset separation requirement under section 21(1)(a) of the ORSO does not require the separation of the assets of the scheme from the assets of the other schemes vested in the administrator in his capacity as administrator of the pooling agreement.

Audit implications

65. For ORSO schemes, it is the responsibility of the pool administrator to prepare annual financial statements for each scheme participating in the pool, and to have those financial statements audited. The ORSO (section 20(7C)) requires that, unless exempted by the MPFA, the pool administrator appoints the same auditor to audit the financial statements of each scheme participating in the pool and all participating schemes should have a common year end. The trustee of a MPF scheme need not prepare individual financial statements for each participating employer.

66. The participation of a scheme in a pooling arrangement can have specific implications for the auditor as the audit evidence that the auditor requires to form the opinion could be derived from several sources.
67. For example, the pool trustee/administrator may appoint an auditor for the schemes administered by him who are not the auditor appointed by his shareholders to be his statutory auditor. In such instances, the auditor for the schemes would consider the extent to which he/she can rely on the work of the trustee's/administrator's auditor in testing the internal controls and systems of the pooling arrangement. It may be more efficient for the auditor of the schemes to independently assess the controls established by the trustee/administrator over the systems used to produce the scheme financial statements.

Abbreviated information for scheme members

68. Many schemes produce abbreviated financial information for distribution to members which summarises the key financial highlights from the audited financial statements.
69. The auditor has no control over the issue of such abbreviated financial information, particularly, when the auditor is not asked to report on it. However, if the auditor becomes aware that such information has been or will be issued, the auditor would take steps towards ensuring that members are not given the impression that such abbreviated financial information itself constitutes audited financial statements. If the auditor has any concerns in this respect, the auditor would communicate them to the trustee/administrator and the auditor would consider the continuing appointment in the light of the trustee's/administrator's response.
70. If the auditor is asked to provide a report, the same concerns apply, and the auditor would make clear in the auditor's report the scope of the work the auditor has carried out, in particular any areas the auditor has not examined. The auditor would ensure that the report specifically refers to the fact that the financial information does not give a true and fair view and would indicate whether the opinion on the full financial statements had been qualified or not.

PART II ADDITIONAL GUIDANCE RELEVANT TO THE AUDITOR OF A MPF SCHEME

General

71. The reference in this Part to a retirement scheme or scheme means a MPF scheme.

Reporting under sections 102 and 106 of the General Regulation

72. Section 95 of the General Regulation requires the trustee to submit the financial statements of the scheme to an auditor annually, for the purpose of independent audit. All schemes, regardless of size or type, must be audited. A copy of the audited financial statements of the scheme is required to be submitted by the trustee to the MPFA within 6 months after the end of the scheme's financial period.

73. The first audit would be required in respect of the first financial period which should commence with the date on which the scheme was first registered under section 21 or 21A of the MPFSO and end on a date not more than 12 months from this date.

Specific audit areas

Investments

74. Under section 28 of the MPFSO, the MPFA has the authority to publish guidelines on forbidden investment practices in relation to a scheme.

75. The General Regulation imposes the following requirements in respect of investment of scheme assets:

- a. a capital preservation fund must comply with the investment restrictions as set out in section 37(2) of the General Regulation;
- b. a scheme cannot enter a repurchase agreement unless it complies with the restrictions as set out in section 51 of the General Regulation;
- c. a scheme cannot lend any securities unless it complies with the restrictions as set out in section 52 of the General Regulation;
- d. an employer sponsored scheme is not allowed to invest more than 10% of the total assets of each constituent fund in "restricted securities" or make a loan other than a loan by way of a deposit with an authorised financial institution (General Regulation Part X);
- e. a scheme must comply with Schedule 1 to the General Regulation which deals with "permissible investments", "currency exposure" and "pooled investment". The general restrictions for investments for a scheme are:
 - i. no more than 10% of the total funds of a constituent fund may be invested in securities and other permissible investments issued by any one person (General Regulation Schedule 1 section 2(1)); and
 - ii. no more than 10% of securities or other permissible investments of a particular class issued by one person may be acquired for the purposes of a constituent fund (General Regulation Schedule 1 section 2(2)).

The general restrictions for investments set out above are not applicable when the investment is made into approved pooled investment funds¹. (The reporting and investment requirements of approved pooled investment funds are set out in relevant guidelines and the MPF Code issued by the MPFA.)

76. The General Regulation (Schedule 1 section 17) states that funds may be invested in a pooled investment fund, which may in turn be invested in one or more other pooled investment funds. Where the trustees of these pooled investment funds and the scheme are not the same, the auditor of the scheme would need to ensure that the trustee has monitoring procedures in place over the trustees of the pooled investment funds. These procedures may include:
- a. obtaining a copy of the report of internal controls and the accompanying auditor's report of the trustees of the pooled investment funds;
 - b. obtaining regular statement of compliance from the trustee that the investment restrictions are not breached; and
 - c. obtaining a copy of the financial statements of the trustee and of the pooled investment funds.
77. The auditor would need to perform such procedures as are considered necessary in order to obtain sufficient appropriate audit evidence to enable the auditor to report whether or not the requirements of section 28 of the MPFSO and sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with as at the end of the financial period and 2 other dates as the auditor preparing the auditor's report may elect, provided that the intervening period between the 2 other dates shall not be shorter than three months. Where a scheme has been in operation for less than a full year and the intervening period between the 2 other dates nominated is less than 3 months, approval must be obtained from the MPFA in writing to use those dates. In planning and performing this work, the auditor should refer to the principles in the Hong Kong Standard on Assurance Engagements (HKSAE) 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" applicable to assurance engagements.

Contributions

78. In respect of completeness of contributions under MPF, section 106(2) of the General Regulation states that information contained in a remittance statement submitted by an employer or particulars given by a self-employed person to the trustee shall be treated as conclusive evidence as to the amount of the member's relevant income. Accordingly, the auditor need not carry out further procedures to satisfy himself/ herself in respect of the completeness of the relevant income.

The auditor's reports

79. Section 102 of the General Regulation requires:
- a. the auditor's report, addressed to the trustee, in relation to the financial statements of a scheme and a financial period of it to state whether or not in the auditor's opinion:
 - i. the financial statements give a true and fair view of the financial position of the scheme as at the end of the period and of the financial transactions of the scheme for the period then ended; and
 - ii. the financial statements have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 of the General Regulation; and

¹ An example of an auditor's report for an approved pooled investment fund is included as Example 9 of Appendix 1 to this Practice Note.

- b. the auditor's report, addressed to the trustee, on a scheme's compliance with certain requirements of the MPFSO and General Regulation to state:
- i. whether or not in the auditor's opinion:
 - proper accounting and other records have been kept during the relevant financial period in respect of the constituent funds of the scheme, the scheme assets and all financial transactions entered into in relation to the scheme; and
 - the requirements specified in the guidelines made by the MPFA under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with in all material respects as at the end of the period and two such other dates in the period as the auditor preparing the auditor's report may elect, provided that the intervening period between such dates shall not be shorter than three months, or a shorter period allowed by the MPFA; and
 - ii. whether or not the assets of the scheme as at the end of the period were subject to any encumbrance, otherwise than as permitted by the General Regulation.
80. In addition, section 106 of the General Regulation requires the auditor to state whether the auditor has obtained all the information and explanations that the auditor has required.
81. Example auditor's reports are included in Appendix 1 to this Practice Note (examples 1 and 2).

Reporting under sections 18 and 115 of the General Regulation

Prescribed capital adequacy requirements

82. The MPFA requires all applicant trustees to meet the prescribed capital adequacy requirements (capital adequacy requirements) when applying for approval as trustee, and all trustees to comply with the capital adequacy requirements at all time.
83. The MPFSO (sections 20A and 20B) empowers the MPFA to suspend or revoke the approval of a trustee for failure to meet financial resources requirements, including capital adequacy requirements.
84. There are essentially two means by which a company can meet the capital adequacy requirements. These are referred to in this Practice Note as "the stand-alone basis" and "the group basis".
85. The stand-alone basis sets requirements for the company itself as follows:
- a. paid up share capital of at least \$150,000,000 (or its foreign currency equivalent);
 - b. net assets of at least \$150,000,000 (or its foreign currency equivalent); and
 - c. assets in Hong Kong of at least \$15,000,000.
86. "Assets in Hong Kong" is defined in section 10 of the General Regulation.

87. The alternate basis of meeting the capital adequacy requirements is the group basis. In this case the applicant trustee must be an associate of:
- a. a company or corporation that is a substantial financial institution (as defined by section 7 of the General Regulation) which provides continuous financial support (as defined under section 12 of the General Regulation) to the applicant trustee; or
 - b. a company or corporation having a subsidiary that is a substantial financial institution and provides continuous financial support to the applicant trustee.
88. Under the group basis, the applicant trustee is only required to maintain paid up share capital and net assets of \$30,000,000. The \$15,000,000 "assets in Hong Kong" requirement must still be met in full.
89. The substantial financial institution must itself have:
- a. a paid up share capital of at least \$150,000,000 (or its foreign currency equivalent) and net assets of at least the same amount. In the determination of net assets, certain subordinated debts may be excluded by virtue of section 7(2) of the General Regulation; and
 - b. given a written undertaking in a form acceptable to the MPFA to the extent that it commits itself to provide financial support to the applicant trustee such that the \$30,000,000 share capital and net asset position of the applicant trustee and the associate relationship between the institution and the trustee will be maintained. A written undertaking under section 12 of the General Regulation needs to be by deed or like form.

Procedures performed by the auditor

90. For the auditor's reports under sections 18 and 115 of the General Regulation, in planning and performing the work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.
91. For the purposes of the auditor's report on the capital adequacy requirements of an applicant trustee, unless the date agreed between the applicant trustee and the MPFA is the financial year end of the applicant trustee, the auditor will be required to design substantive procedures at the date specified to enable the auditor to report whether or not the capital adequacy requirements have been complied with.
92. Such substantive procedures may include:
- a. obtaining evidence to support the amount of paid up share capital at the reporting date;
 - b. obtaining a balance sheet of the applicant trustee at the reporting date and reviewing the net asset position of the applicant trustee at that date;
 - c. obtaining evidence to support the existence of assets at the reporting date and the basis on which the assets are valued at that date;
 - d. extending existence testing of assets to verify the requirements for assets in Hong Kong are being met;
 - e. searching for unrecorded liabilities at the reporting date;
 - f. reviewing transactions before and after the balance sheet date to consider the reasonableness of the presentation of the balance sheet position at the reporting date;

- g. obtaining and reviewing the written undertaking in respect of continuous financial support as specified under section 12 of the General Regulation.

If a group basis of meeting the capital adequacy requirements is chosen, the auditor would obtain evidence that the institution supporting the applicant trustee qualifies under the General Regulation and, where necessary, evidence of appropriate approval by the MPFA is provided.

- 93. If the reporting date is to be the financial year end of the company and the company is required to prepare financial statements which have been audited, then the auditor would have regard to the extent of the substantive tests performed for the audit of the financial statements in the consideration of the extent of the procedures in paragraph 92 above to be carried out.
- 94. For the purposes of the reporting on ongoing capital adequacy requirements, the auditor would plan to include the procedures suggested in paragraph 92 above in respect of the financial year end and the two dates selected to test the compliance with capital adequacy requirements in the audit work. However, there are other matters which the auditor may consider in forming the opinion:
 - a. the frequency by which management accounts or other financial information is prepared may influence the dates chosen by the auditor, especially if the audit procedures adopted plan to place reliance on the controls surrounding the preparation and review of the management information;
 - b. the auditor may choose to rely on the internal control processes adopted by the trustee in ensuring that capital levels can be monitored at all times, and test the controls in place in conjunction with a series of substantive tests.

The auditor's reports pursuant to sections 18 and 115 of the General Regulation

- 95. The General Regulation (section 18) requires that any applicant trustee applying to be an approved trustee must cause a report to be prepared by its auditor. The auditor's report is addressed to the applicant trustee and must state, in the opinion of the auditor, whether or not the applicant trustee complies with the capital adequacy requirements, as set out in section 11 of the General Regulation, on a specified date (agreed between the MPFA and the applicant trustee). The date referred to must be on or before the date on which the MPFA approves the applicant trustee as a trustee.
- 96. The auditor's report may contain such observations, elaborations, qualifications or explanations as the auditor considers necessary. The MPFA has the power to request remedial action by the applicant trustee within a specified time period. In such circumstances a second auditor's report would be required to be prepared by the auditor, stating whether or not in the auditor's opinion the qualification or matter raised has been rectified.
- 97. With respect to the ongoing capital adequacy requirements, section 114 of the General Regulation requires that the trustee prepares a report to the MPFA, stating whether or not the capital adequacy requirements were complied with throughout the period. If the requirements were not complied with, the reasons for non-compliance should be stated in the trustee's report.
- 98. Section 115 of the General Regulation requires the auditor to review the section 114 report issued by the trustee and issue an auditor's report, stating whether or not, in the auditor's opinion, the capital adequacy requirements were complied with at the financial year end of the approved trustee, and two other dates during the financial year, such dates being selected by the auditor. The two dates selected must be at least three months apart or such a shorter period the MPFA may allow. If the requirements were not met, the reasons for non-compliance are required to be stated in the auditor's report.

99. Both reports under sections 114 and 115 are to be submitted to the MPFA within six months of the financial year end of the trustee. In practice the requirements of sections 114 and 115, when taken together, will mean that the trustee will be required to prepare a draft section 114 report in time for the auditor to review and attach the auditor's report under section 115.
100. Suggested reports suitable for reporting on compliance with prescribed capital adequacy requirements are included in Appendix 1 to this Practice Note (examples 3 and 4).

Reporting under section 74(5)(b) of the General Regulation

Trustee to review service providers' reports

101. In accordance with section 74 of the General Regulation, the trustee requires each service provider appointed or engaged by the trustee to report any material breach of obligations or material changes to the trustee.
102. On an annual basis, the service provider is required to submit to the trustee within four months after the scheme's year end date, the audited financial statements together with a report from its auditor stating whether or not, in the auditor's normal course of duties², the auditor has become aware of:
- a. any failure of the service provider to comply with the service provider's obligations under the contract of appointment or engagement entered into between the trustee and the service provider; and
 - b. any false declaration made by the service provider to the trustee or any other person, and if so, give particulars of the failure or false declaration.

The auditor's report pursuant to section 74(5)(b) of the General Regulation

103. A copy of an example auditor's report as mentioned in paragraph 102 above is included in Appendix 1 to this Practice Note (example 5).

Reporting under section 113 of the General Regulation

Trustee's report on control objectives and internal control measures

Requirements of trustee

104. The MPFA requires all trustees to maintain an appropriate internal control framework with respect to the management and administration of schemes. Trustees are also required to submit an annual report to the MPFA on their control objectives and internal control measures (Trustee's Report).
105. Reference would be made to section 39 of the General Regulation for details of the control objectives and internal control measures that must be established for each scheme and be maintained at all times while the scheme is registered.
106. Certain schemes may be exempted from these requirements. Reference would be made to the relevant regulation for further information.
107. The General Regulation specifies the requirements for trustees to report to the MPFA and reference would be made to the General Regulation for details of these requirements. A Trustee's Report would normally set out:
- a. a statement of responsibility;

² The auditor should obtain management representation specifically for reporting under section 74(5)(b) of the General Regulation.

- b. the trustee's control objectives in relation to the safeguarding of scheme assets, the recording of transactions and the compliance with the General Regulation;
 - c. details of each of the specific control procedures and measures designed to achieve the control objectives;
 - d. details of any significant changes to the control objectives, procedures and measures during the period;
 - e. details of any exceptions to the control objectives, procedures and measures during the period; and
 - f. an assertion by the trustee that it has reviewed the control objectives, and the control procedures and measures in operation.
108. In order that the statement by the trustee is fairly described, the trustee should include in the Trustee's Report a description of any material weaknesses identified which have, in its view, affected whether control procedures and measures are in place, or reduced the effectiveness, or prevented the operation, of control procedures and measures, if those weaknesses were not themselves identified and rectified within an appropriate time.

Requirements of the auditor

109. The MPFA requires the Trustee's Report on internal controls to be reviewed by the auditor (section 113 of the General Regulation), and the auditor is required to report to the trustee:
- a. whether or not appropriate control objectives were established and maintained for the scheme during the period to which the report relates;
 - b. if appropriate control objectives were so established and maintained, whether or not effective internal control measures were established and maintained for the purpose of achieving those objectives; and
 - c. whether or not those internal control measures (if any) were likely to have been sufficiently effective to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented.
110. The auditor is also required to state:
- a. whether or not, during the course of the review of the Trustee's Report, the auditor became aware of any shortcomings in the internal control measures that could materially affect the operation of the scheme (including its financial position) or the financial interests of scheme members; and
 - b. details of any such shortcomings the auditor became aware of.

Requirements of both the trustee and auditor

111. Both the Trustee's Report and the auditor's report on a review thereof under sections 112 and 113 of the General Regulation respectively are submitted to the MPFA in accordance with section 111 of the General Regulation. In practice the requirements of sections 112 and 113 of the General Regulation when taken together, will mean that the trustee will be required to prepare a draft Trustee's Report in time for the auditor to review and attach the auditor's report thereto under section 113 of the General Regulation.
112. The MPFA has issued guidelines relating to the reporting requirements of the trustee and auditor in respect of the internal control objectives and control measures for each scheme in "Guidelines on Internal Control Report for each Registered Scheme" ("MPFA Guidelines II.6").

113. It is recognised that the control objectives and procedures may differ from trustee to trustee depending on the trustee's own assessment and tolerance of the risk level in the organization, its specific operating system, size of the business, types of products on offer etc.
114. The MPFA Guidelines II.6 is not intended to prescribe specific control systems for all schemes and the measures described in the MPFA Guidelines II.6 are not intended to be exhaustive and in many instances alternative control procedures and measures may be equally appropriate and acceptable.
115. Even though trustees are not required to report on all the control objectives and measures applicable to their schemes, trustees are expected to ensure that a proper system of internal controls is in place for all aspects of their schemes' operations and are expected to ensure that as a minimum the requirements specified by the MPFA are complied with.
116. The auditor is expected to report on the design effectiveness of the internal controls and is therefore not expected to test or ascertain whether the control objectives or internal control measures were actually implemented during the period.
117. It is recognised that the auditor of the trustee may be different from the auditor of the scheme. It is also possible that different auditors may be appointed to each scheme managed by the same trustee.
118. If the Trustee's Report relates to only one scheme, then the Trustee's Report is submitted to the auditor of the scheme for review.
119. If the Trustee's Report relates to 2 or more schemes and the trustee specifies the financial period of one of the schemes to which the report relates as the relevant period nominated under section 111(1)(b) of the General Regulation, then the Trustee's Report is submitted to the auditor of that scheme for review.
120. If the Trustee's Report relates to 2 or more schemes and the financial year of the trustee is the relevant period nominated under section 111(1)(b) of the General Regulation, then the Trustee's Report is submitted to the auditor of the trustee for review.

Procedures performed by the auditor

121. In planning and performing this work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.

Terms of engagement

122. In agreeing the terms of the engagement, the auditor would exclude liability in respect of any loss or damage caused by, or arising from, fraudulent acts, misrepresentation or wilful default on the part of the trustee, its directors, employees or agents. The auditor would also exclude liability to third parties. They would normally obtain a limitation in aggregate of the auditor's liability. It should be noted that it is not possible to limit liability in relation to death or personal injury caused by the negligence (within the meaning of section 2 of the Control of Exemption Clauses Ordinance) of the auditor.

Planning the engagement

123. In addition to the requirements contained in HKSAE 3000, the following would need to be considered by the auditor:
- a. the structure with respect to a scheme operation may be different for each scheme. The auditor would need to understand the structure adopted in the administration and management of the scheme, i.e. who is and what are the custodian's responsibilities, who is and what are the trustee's responsibilities etc;

- b. the terms of the contract between the trustee and service providers such as the custodian, third party administrator and the investment manager of the scheme;
- c. the nature of services provided by the service providers and the extent to which the trustee's internal control measures interact with those of the service providers;
- d. the methods adopted by the trustee to evaluate the appropriateness of the specified control objectives of the scheme and the effectiveness of the major procedures and internal control measures for achieving those objectives;
- e. the type and extent of evidence supporting the trustee's evaluation/assertion about the effectiveness of the internal control procedures and measures;
- f. the nature of control procedures relevant to the responsibility of the trustee in ensuring that a proper system of internal controls is in place for all aspects of the scheme's operation; and
- g. matters affecting the industry, such as financial reporting practices, economic conditions, amendments to ordinances and regulations and technology changes.

Situations where part of the trustee's responsibilities are outsourced to a third party

124. The ultimate responsibility with respect to the implementation of, and ongoing compliance with, the necessary internal controls framework rests with the trustee. Where a trustee has delegated certain of its functions to another service provider, the auditor needs to consider the impact of this on the overall engagement with reference to HKSA 402 "Audit Considerations Relating to an Entity Using a Service Organization".

Evaluating design effectiveness

125. To evaluate the effectiveness of control procedures, the auditor would obtain a general understanding of the control environment and information system to identify matters that are likely to have a significant impact on the effectiveness of particular control procedures and measures.
126. Procedures to evaluate the effectiveness of a specific control are concerned with whether that control is suitably designed to comply with the suggested control measures in the MPFA Guidelines II.6. Such procedures will vary depending upon the nature of the specific control, the nature of the trustee's documentation of the specific control, and the complexity and sophistication of the trustee's operations and systems.
127. The auditor would evaluate the effectiveness of the control procedures based on the identified control objective. This evaluation would be based on whether the control procedures have been suitably designed to reduce to an acceptably low level the risks that threaten achievement of the objectives relevant to the area of activity. Where the auditor is unable to identify control procedures designed to provide reasonable assurance about the reduction of risk, this would constitute a weakness in relation to design effectiveness.
128. The auditor would focus on the significance of controls in achieving the control objectives rather than on specific controls in isolation. The absence or inadequacy of a control designed to achieve specific criteria may not be a deficiency if other controls specifically address the same criteria.

Testing operating effectiveness

129. It is recognised that the auditor cannot be aware of all the relevant control assertions made by the trustee in its report on internal controls, in particular as these might be affected by the other service providers' control procedures. The auditor does not have the responsibility to identify or test all the control objectives and procedures which have been included in the description of the control report prepared by the trustee and the auditor is not expected to test

or ascertain whether the control objectives or internal control measures were actually implemented during the period under review.

130. However it is envisaged that in order to enable the auditor to form an opinion on the design effectiveness and on whether those internal control measures were likely to have been sufficiently effective to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented, the auditor would be required to carry out a limited level of testing.
131. These tests would ordinarily include procedures such as enquiries of appropriate personnel, inspection of relevant documentation, observation of the trustee's operations, and reapplication of, and reperformance of, the control measures to a certain extent.
132. Tests of operating effectiveness are concerned with how the control procedures were applied, the consistency with which they were applied, and by whom they were applied. The auditor would also need to consider the period of time over which the control procedures were applied.
133. The nature of a control procedure often influences the nature of tests of operating effectiveness that can be performed. For example, the auditor may examine evidence regarding a control where such evidence exists, however documentary evidence regarding some control procedures often does not exist. In these circumstances, the tests of operating effectiveness may consist of enquiry and observation only.
134. The decision about what comprises sufficient appropriate evidence is a matter of professional judgement. The auditor would consider for example:
 - a. the significance of the control procedure in achieving the relevant objective; and
 - b. the nature and extent of any tests of operating effectiveness performed by the trustee (management, internal auditing or other personnel).
135. Management, internal auditing or other personnel of the trustee may provide the auditor with the results of their tests of the operating effectiveness of certain aspects of internal control. Although the auditor would consider the results of such tests when evaluating operating effectiveness, it is the auditor's responsibility to obtain sufficient appropriate evidence to support the auditor's conclusion and, if appropriate, corroborate the results of such tests. When evaluating whether sufficient appropriate evidence has been obtained, the auditor would consider that evidence obtained through direct personal knowledge, observation, re-performance (to a limited extent only), and inspection is more persuasive than information obtained indirectly, such as from management, internal auditing or other personnel of the trustee. Furthermore, judgements about the sufficiency and appropriateness of evidence obtained and other factors affecting the auditor's conclusion, such as the significance of identified control weaknesses, are those of the auditor.

The auditor's report pursuant to section 113 of the General Regulation

136. The auditor's report is addressed to the trustee.
137. The auditor's report depends on the specific terms of engagement agreed with the trustee, but it is normally expected to contain:
 - a. the title;
 - b. the addressee;
 - c. a statement as to the scope of the auditor's work;

- d. a section dealing with the respective responsibilities of the trustee and auditor:
 - i. if not included in the Trustee's Report, a statement that it is the responsibility of the trustee to design, implement and maintain the control procedures. It should also specify that it is the trustee's responsibilities to ensure adequate controls are implemented in the monitoring of other service providers where some or all of the trustee's responsibilities have been outsourced to a third party; and
 - ii. the auditor's responsibilities;
 - e. a section dealing with the basis of conclusion:
 - i. a statement that the engagement was conducted in accordance with HKSAE 3000 and with reference to this Practice Note;
 - ii. a statement that the auditor is not required to verify whether the controls were in fact implemented during the period under review and that the auditor have performed very limited tests on the control procedures; and
 - iii. a statement that the auditor's work was limited to ensuring whether control measures designed by the trustee were in line with those recommended in the MPFA Guidelines II.6;
 - f. a statement that all control systems have inherent limitations and accordingly, errors and irregularities may occur and not be detected. Also, they cannot guarantee protection against fraudulent collusion especially on the part of those holding positions of authority or trust;
 - g. the auditor's conclusion:
 - i. a statement as to whether or not appropriate control objectives were established and maintained for the scheme during the period to which the report relates;
 - ii. a statement as to whether or not effective internal control measures were established and maintained for the purpose of achieving those objectives during the period to which the report relates; and
 - iii. a statement as to whether or not those internal control measures (if any) were likely to have been sufficiently effective, in all material respects, to provide a reasonable assurance that the control objectives established and maintained for the scheme would be achieved if those measures were fully and properly implemented;
 - h. a statement as to whether or not, during the course of the review of the Trustee's Report, the auditor became aware of any shortcomings in the internal control measures that could materially affect the operation of the scheme (including its financial position) or the financial interests of scheme members;
 - i. details of any such shortcomings that the auditor became aware of; and
 - j. a statement as to the intended use of the report.
138. A suggested auditor's report suitable for such an engagement is included in Appendix 1 to this Practice Note (example 6).

Report modifications

139. The auditor would modify the auditor's report if any of the following conditions exist:
- a. there is a material weakness in the internal controls;
 - b. there is a restriction on the scope of the engagement; or
 - c. the trustee presents an assertion about only a segment of the internal controls, and not all the control objectives and control procedures as outlined in the General Regulation and the MPFA Guidelines II.6 are included in the Trustee's Report.

Reporting material weaknesses in the internal controls

140. Where the auditor has become aware of material weaknesses which are inadequately described in the Trustee's Report, the auditor would need to issue a modified conclusion in the auditor's report and provide such a description in the auditor's report or a reference to such a description in the Trustee's Report. The auditor would also refer to any inaccurate or inadequate description of the trustee's control procedures in the Trustee's Report of which the auditor has become aware. It would also be helpful for the status of any corrective action taken by the trustee in relation to any reported weakness to be included in the auditor's report.
141. On occasions the trustee may seek to alter control objectives in order to prevent a modification in the report by the auditor. The auditor would assess carefully the appropriateness of any changes proposed to the Trustee's Report and the risks arising from this and consider the conclusion in the light of that assessment.
142. The trustee may express its intention to rectify a weakness at some future time. No conclusion would be given by the auditor in relation to such an expressed intention and the auditor's report would specifically state that fact. The auditor may, at the request of the trustee, test and report on any corrective action taken in respect of a weakness.
143. The engagement is not intended to be planned and carried out in such a way that all control weaknesses that may possibly exist within the trustee can be identified during the course of the engagement. Furthermore as the auditor is not expected to test whether the control objectives and internal control measures were actually implemented during the period under review, the auditor cannot be expected to identify all control weaknesses that may possibly exist within the trustee's operation over the management and administration of schemes. This limitation must be clearly stated in both the engagement letter and the auditor's report.
144. However the auditor would also consider the statutory requirements to report material weaknesses to the MPFA (see paragraphs 147 to 151 below).
145. During the course of the engagement, if the auditor becomes aware of significant deficiencies in the trustee's system of internal control, to the extent that the shortcomings identified during the course of the auditor's work may materially affect the operation and financial position of the scheme. The auditor is required to include details of the shortcomings of which the auditor became aware in the report.
146. The auditor's conclusion is based on the procedures determined to be necessary for the collection of sufficient appropriate evidence, that evidence being persuasive rather than conclusive in nature. The assurance provided by the auditor on the effectiveness of internal controls is however restricted because of the nature of internal controls and the inherent limitations of any set of internal controls and their operations. These limitations include:
- a. the trustee's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived;
 - b. most internal controls tend to be directed at routine rather than non-routine transactions/events;

- c. the potential for human error due to carelessness, distraction or fatigue, misunderstanding of instructions and mistakes in judgement;
- d. the possibility of circumvention of internal controls through the collusion of employees with one another or with parties outside the trustee;
- e. the possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding a control procedure;
- f. the possibility that management may not be subject to the same internal controls applicable to other personnel; and
- g. the possibility that internal controls may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Communications between the auditor and the MPFA

Ad hoc reports to the MPFA under section 103 of the General Regulation

147. Section 103 of the General Regulation requires the auditor to report the following matters to the MPFA in writing, if the auditor becomes aware of them while performing the duties:
- a. any matter that would cause the auditor to qualify the auditor's report on the financial statements of the scheme;
 - b. non-compliance with the following sections of the General Regulation:
 - i. keeping proper accounting records (section 77); and
 - ii. keeping a separate account for each scheme member (section 78);
 - c. any transaction that has resulted in a misappropriation of the funds of the scheme or the scheme assets;
 - d. any payment from the funds of the scheme that is materially prejudicial to the interests of scheme members except where the trustee has fully reimbursed the scheme after the payment has been brought to the notice of the trustee;
 - e. any combining of the scheme assets with the funds of the trustee or the assets of any persons except where the custodian:
 - i. also holds the assets of one or more other scheme(s) or other financial schemes or undertakings; and
 - ii. keeps a separate account of the scheme assets and those other assets in such a way as to enable them to be separately identified;
 - f. non-compliance with the legislation and guidelines on forbidden investment practices;
 - g. non-compliance with section 135 of the General Regulation which requires the trustee to inform the MPFA in writing within 7 days after the end of the settlement period of non-payment of or discrepancy in mandatory contribution.
148. The auditor has no obligation to seek out grounds for making a report under section 103 of the General Regulation, nor does the section place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover a matter upon which the MPFA may need to act. It is only when the auditor does become aware in the

ordinary course of the work of such a matter, or of circumstances which suggest the existence of such a matter, that the auditor would consider reporting under this section.

149. In the event that the auditor becomes aware of any matters in paragraph 147 above, the auditor may bring the matter to the trustee's attention in writing and request an explanation of the matter. The trustee is required to rectify the situation within such period as the auditor considers to be reasonable. If the trustee complies with the auditor's request in this respect, the auditor is not required to report the matter to the MPFA. However, the auditor must not give such notice:
- a. if the matter relates to a transaction, which in the opinion of the auditor, is or has resulted in a material misappropriation of the funds of the scheme or the scheme assets; or
 - b. if bringing the matter to the attention of the trustee could reasonably be expected to detrimentally affect the interests of the scheme members.
150. If on becoming aware of matters reported in accordance with paragraph 147 above, the MPFA is of the opinion that the matter is capable of being rectified, the MPFA may ask the trustee to rectify the matter. As soon as practicable after giving such a direction, the MPFA will request the auditor in writing to provide the MPFA with a further report as to whether or not the trustee has rectified the matter.
151. If upon receiving a request in writing from the MPFA to provide to them a further report as to whether or not the trustee has rectified the matter as specified in the letter, the auditor must as soon as practicable after the end of the period specified in the notice and at the expense of the trustee, issue such a report to the MPFA.

Statutory protection under section 42A of the MPFSO

152. The MPFSO (section 42A) introduces statutory protection for current and prior auditors from liability to their client for breach of confidentiality. Such statutory protection is available when the auditor communicates directly with the MPFA (whether or not in response to a request of the MPFA) in good faith, if the auditor became aware of the matter in the capacity as the auditor and on matters relevant to a function of the MPFA.
153. Section 42A of the MPFSO does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the MPFA. It provides a statutory mechanism whereby the auditor may make matters known to the MPFA without breaching the duty of confidentiality.
154. Confidentiality is an implied term of an auditor's contract with the client, but in certain circumstances and under conditions specified in section 42A of the MPFSO it does not prevail, since the auditor is entitled to communicate information or opinions on a matter relating to the business or affairs of the client relevant to the MPFA's functions without the duty of confidentiality owed to the client being regarded as having been breached.
155. Examples of circumstances in which the auditor may communicate a matter to the MPFA under section 42A of the MPFSO include:
- a. the auditor considers scheme members have incurred, or are at significant risk of incurring, a material loss as a result of a trustee carrying on business in a manner that is not fit and proper or that is in breach of the MPFSO or the General Regulation;
 - b. there is evidence of:
 - i. fraud, dishonesty or serious incompetence; or

- ii. serious failure to observe requirements of the MPFSO or the General Regulation or conditions imposed on the trustee by the MPFA if such failure impacts scheme members;
 - 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, requirements set by the MPFA to which the trustee or the scheme is subject; and
 - d. the position is such that because of a significant risk which is material to the collective interests of scheme members, the scheme members' interests would be better safeguarded if the MPFA were aware of the position.
156. Clearly the potential nature of matters which may be reported is very wide, but as explained in paragraph 159 below this does not, of itself, require the auditor to extend the scope of the work in order to discover matters and it will only be in exceptional circumstances that the auditor may choose to seek statutory protection.
157. Any protected communication can be made either on the auditor's initiative or in response to a request from the MPFA for information. The auditor would normally co-operate with the MPFA and respond to any requests from the MPFA for information, provided the auditor has no reason to doubt that the request is relevant to the MPFA's functions. The auditor may communicate a matter to the MPFA with the protection of section 42A of the MPFSO regardless of the source of that information, provided the auditor became aware of the matter in the capacity as the auditor of the scheme and the auditor does so in good faith.
158. Matters of which the auditor becomes aware "in the capacity as the auditor" may not be restricted to those matters identified by the auditor during the course of the audit work. The auditor may become aware of a matter which is relevant to the functions of the MPFA during the course of the work for the trustee 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 MPFA 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.
159. The auditor cannot be expected to be aware of all circumstances which, had the auditor known of them, would have led him/ her to exercise the right to communicate under section 42A of the MPFSO. This section does not require the auditor to change the scope of the audit or other work for the client, nor the frequency or timing of the visits. The auditor has no obligation to seek out grounds for making a report under section 42A of the MPFSO. The section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover a matter upon which the MPFA may need to act. It is only when the auditor does become aware in the ordinary course of the work of such a matter, or of circumstances which suggest the existence of such a matter, that the auditor would consider using the protection of section 42A of the MPFSO.
160. The MPFA recognises that it would not be appropriate for the auditor to report information which the auditor has obtained or matters which the auditor has identified through the professional relationship with another client, even though the information obtained or the matters identified may relate to a trustee or a scheme. However, the MPFA expects the trustee to advise its auditor when it appoints a third party (including another department of the same firm) to review, investigate or report on any aspects of its records and systems and to provide the auditor with copies of reports by such a third party promptly after their receipt. The auditor can, if appropriate, make enquiries in the capacity as the auditor to ascertain whether any findings of the reports should be reported to the MPFA.
161. It should be noted that section 42A of the MPFSO will not provide protection to the auditor where the auditor could be held to have acted maliciously or in bad faith or if the information reported is outside the scope of that section. The MPFSO does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently

affected, by the auditor's action in reporting to the MPFA. The auditor would consider taking legal or other professional advice before making the decision about whether, or in what manner, to report and in order, for example, to ensure that the form and content of the auditor's report are such as to secure the protection of section 42A of the MPFSO and that it only includes relevant material.

162. The auditor is protected, however, even if the information which the auditor communicates fall short of proof, or the opinion which the auditor communicates cannot be verified. An auditor who can demonstrate that he/ she has acted reasonably and in good faith in informing the MPFA of a reportable matter would not be held in breach of duty to the 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.
163. Whilst no breach of statutory duty may arise, it should be appreciated that there is no protection given by the MPFSO, if the auditor, after becoming aware of an occurrence, fail to report, promptly, or at all, to the MPFA. Furthermore, it should be recognised that speed of reporting is likely to be important in order to enable the MPFA to protect the interests of scheme members.

MPFA may require certain reports to be prepared by the auditor under section 30 of the MPFSO

164. Under section 30 of the MPFSO, if at any time the MPFA reasonably believes that circumstances exist or have existed which may prejudice the accrued benefits of a member of a scheme, it may require a trustee, by written notice, to arrange for the auditor (who must be approved by the MPFA) to investigate whether such circumstances exist, or have existed, and to investigate any other matter relating to the trustee or the scheme as specified by the MPFA.
165. A copy of the auditor's report on the investigation must be provided to the MPFA and may be published or supplied to a scheme member that the MPFA believes may have been prejudiced.

Rights and duties of the auditor

Offence to obstruct

166. Under section 107 of the General Regulation, it is an offence for the trustee of a scheme or a service provider appointed or engaged:
- a. not to allow the auditor of the scheme access to all accounting records and other records relating to the scheme and to the trustee of the scheme that are in the possession of that trustee or service provider;
 - b. not to give any information or explanation to the auditor as and when reasonably required by the auditor; and
 - c. to obstruct, hinder or delay the auditor in the performance of the auditor's duties or the exercise of the auditor's powers.

Offence to make false or misleading statement

167. A person who, in any document given to the auditor of a scheme, makes a statement that the person knows to be false or misleading in a material respect, or recklessly makes a statement which is false or misleading, commits an offence and is liable on conviction:
- a. to a fine and imprisonment for 12 months on the first occasion on which the person is convicted of the offence; and
 - b. to a fine of HK\$200,000 and to imprisonment for 2 years on each subsequent offence.

Certain statements of the auditor not admissible evidence

168. The following statements made by the auditor are not admissible in evidence in any civil or criminal proceedings against the auditor and they may not be made the grounds of a prosecution or other legal proceeding against the auditor:
- a. a statement made by the auditor in a notice to the MPFA under Part VIII of the General Regulation; or
 - b. a statement made in answer to an inquiry by the MPFA; or
 - c. reasons for the auditor's removal or resignation from office; or
 - d. reasons for not seeking reappointment.

Removal and resignation of the auditor

169. The removal of the auditor by the trustee will take effect if the auditor and the MPFA are notified in writing within 2 working days after the removal.
170. The auditor must write to the MPFA, within 2 working days of receiving the notice from the trustee, giving reasons why, in the auditor's opinion, he/ she was removed from office.
171. The auditor of a scheme may resign from office by giving written notice to the trustee.
172. An auditor who does not wish to be re-appointed for a further period, if the initial appointment was for a specified period, must notify the trustee in writing.
173. Where the auditor determines to resign in the circumstances set out in paragraphs 171 and 172 above, the written notice of this fact to the trustee must be accompanied by:
- a. a statement that, to the best of the auditor's knowledge and belief, there are no circumstances relating to the resignation or decision not to seek reappointment that would prejudicially affect the interests of the scheme members to a material extent; or
 - b. a statement specifying the circumstances giving rise to the resignation or decision not to accept re-appointment.
174. If a statement under paragraph 173(b) above is given to the trustee, a copy of the notice must be given to the MPFA within 2 working days after giving the notice to the trustee.

PART III
ADDITIONAL GUIDANCE RELEVANT TO
THE AUDITOR OF AN ORSO SCHEME

General

175. The reference in this Part to a retirement scheme or scheme means an ORSO scheme.

Appointment of the auditor

176. The ORSO (section 68) requires any statement, report or other document to be prepared by an auditor in respect of a Hong Kong domiciled scheme to be prepared by a Certified Public Accountant (Practising) as defined by section 2 of the Professional Accountants Ordinance.

177. For an offshore scheme, they must be prepared by a Certified Public Accountant (Practising) or any person who may lawfully practise as a professional accountant in the country or jurisdiction which is the domicile of the scheme and who holds such qualification as the MPFA may accept as being of a standard comparable to that of a Certified Public Accountant (Practising).

Reporting under section 20 of the ORSO

178. The ORSO (section 20) requires the administrator of a scheme to submit the financial statements of the scheme to an auditor annually, for the purpose of independent audit. With few exceptions (see section 20(5) of the ORSO), all schemes, regardless of size or type must be audited. A copy of the audited financial statements of the scheme is required to be submitted by the administrator to the MPFA within 6 months after the end of the scheme's financial period.

179. The first audit would be required in respect of the first financial period ending after the scheme is registered.

Specific audit areas

Investments

180. Section 27 of the ORSO sets out the investment requirement for an ORSO scheme. Section 27(2) imposes the following requirements in respect of investment of scheme assets:

- a. not more than 10% of the assets of the scheme shall consist of restricted investments;
- b. no assets of the scheme shall consist of a loan to the relevant employer of the scheme or an associate of the relevant employer;
- c. subject to subsection (3), no asset of the scheme acquired on or after 15 October 1993 shall consist of investments in the share capital of a body corporate which share capital is not –
 - i. listed on a recognized stock market as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance; or
 - ii. publicly listed on a specified stock exchange as defined in that section.

For further details of the requirements, the auditor is required to refer to section 27 of the ORSO.

181. The auditor would need to perform such procedures as are considered necessary in order to obtain sufficient appropriate audit evidence to enable the auditor to report as to whether or not the requirements of section 27(2) of the ORSO in respect of investment restrictions have been complied with as regards the scheme as at the last day of the year and two other dates in the year as the auditor may elect, provided that the intervening period between all such dates shall not be shorter than three months. Where a scheme has been in operation for less than a full year and the requirements of section 27(2) cannot be satisfied in full, it is recommended that the auditor would select three dates which may not necessarily be three months apart. In planning and performing this work, the auditor should refer to the principles in the HKSAE 3000 applicable to assurance engagements.

Contributions

182. The ORSO (section 20) also requires the auditor to include a statement as to whether or not, in the auditor's opinion, contributions payable to the scheme during the financial year have been paid in accordance with the scheme rules or the relevant undertaking under which they were payable.
183. The wording of the opinion on contributions is more specific than the opinion required on the financial statements. It requires the auditor to consider the amounts of contributions payable to the scheme and, where the trust deed or rules are specific, the dates of payment.
184. It may be necessary for the auditor to consider whether the results of audit tests or evidence on contributions require a qualified opinion to be given on contributions. Matters to be considered in this respect include the opinion in Form A issued by the employer's auditor (paragraphs 196 - 215 below) and whether any discrepancies favour one particular member or group of members and the extent to which the growth of the fund has suffered because of a failure to pay contributions to the scheme in a proper manner.
185. The auditor may, for example, in the case of a scheme having several participating employers, be unable to obtain sufficient evidence on contributions to give an unqualified opinion. The scope of the examination might be expressly stated as being limited to the transactions as recorded in the books of the scheme.
186. Section 27(2) of the ORSO prohibits loans from the scheme to the employer. Where contributions are outstanding these may, under some circumstances, become de facto loans.

Accrued benefits

187. The financial statements of a retirement scheme are required to disclose:
- a. the liability of the scheme in respect of the benefits which have accrued to members and beneficiaries as a result of their membership of the scheme up to the financial year end of the scheme (aggregate past service liabilities); and
 - b. the benefits to which members would have been entitled in the event that they had resigned from membership of the scheme as at the financial year end date (aggregated vested liabilities). These liabilities are calculated differently depending upon the type of the retirement scheme and therefore the auditing procedures vary.
188. The aggregate past service liability to members and beneficiaries of a defined contribution scheme is the accumulated contributions and allocated net earnings of the scheme. This is normally equivalent to the difference between the carrying amounts of the assets and the other liabilities (including forfeitures available to the employer by way of offset against future contributions or cash refund) of the scheme as at the financial year end date, less any reserves or other net earnings which have not been allocated for the benefit of members. This is normally the amount shown as the total balances of the members' accounts.

189. The aggregate past service liability for defined benefit schemes is the present value of the portion of expected future benefit payments which arise from membership of the scheme up to the financial year end.
190. The amount of the liability depends upon an actuarial review which makes reference to the scheme rules and assumptions such as expected future salary levels, mortality rates and membership turnover.
191. The gross liability is discounted to its present value by applying a discount rate consistent with the rate of return that the scheme would anticipate that it could achieve if, at the financial year end date, sufficient funds were available to meet accrued benefits as they fall due.
192. The procedures appropriate to this aspect of the audit usually include the review of the work of the actuary, which is discussed in paragraphs 25 to 41 above.
193. The aggregate vested liability of a defined contribution scheme is the accumulation of the members' contributions plus the appropriate proportion of the employer's contributions determined by the governing rules of the scheme and the net earnings of the scheme allocated on both balances as at the financial year end date. The aggregate vested liability of a defined benefit scheme is determined by the governing rules of the scheme and is generally calculated by the actuary on the basis of length of service and the salaries of the members as at the financial year end date.

The auditor's reports

194. Section 20 of the ORSO requires:
- a. the auditor's report in relation to the financial statements of a scheme and a financial year of it to state:
 - i. whether or not in the auditor's opinion the financial statements give a true and fair view of the disposition, at the last day of the year, of the scheme assets and liabilities and of its financial transactions for the year then ended;
 - ii. where:
 - the auditor has been denied access to the employer's books and records in contravention of section 20(7) of the ORSO; or
 - the auditor has not been given necessary information and explanations as required by section 20(7) of the ORSO,
 such fact; and
 - iii. such other information as the MPFA may specify in guidelines issued by it; and
 - b. the auditor's report on a scheme's compliance with certain requirements of the ORSO to state whether or not in the auditor's opinion:
 - i. proper accounts and records have been kept as regards all assets, liabilities and financial transactions of the scheme;
 - ii. where the scheme is a defined benefit scheme, the relevant undertaking has been complied with;
 - iii. where the scheme is a defined contribution scheme,
 - contributions have been made in accordance with the terms of the scheme; and

- a shortfall between the scheme's assets and the scheme's aggregate vested liability exists, and if so stating the amount of such shortfall at the last day of the year;
- iv. as at the end of the year the assets of the scheme were subject to any assignment, charge, pledge or other encumbrance except:
- the trust (if any) governing the scheme;
 - any charge or pledge created for the purposes of securing loans necessary for meeting the liabilities of the scheme; and
 - any option to acquire for valuable consideration any interest in the assets of the scheme granted in the normal course of business; and
- v. the requirements of section 27(2) of the ORSO in respect of investment restrictions have been complied with as regards the scheme as at the last day of the year and two such other dates in the year as the auditor may elect, provided that the intervening period between such dates shall not be shorter than three months.
195. The auditor's reports are addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's reports would be addressed to the administrator. Example auditor's reports are included in Appendix 1 to this Practice Note (examples 7 and 8).

Responsibility and scope of work of the employer's auditor under section 20(7A) of the ORSO

196. The ORSO (section 20(7A)) requires the relevant employer to appoint an auditor ("the employer's auditor") who provides confirmation to the administrator's auditor not later than four months after the scheme's financial year end on such matters as may be reasonably required in order for the administrator's auditor to discharge his obligations. The ORSO defines "the administrator's auditor" as being the auditor who is forming the opinion on the scheme's financial statements. The employer's auditor does not need to be the same as the administrator's auditor. Separate engagement letters are required for the appointments of the employer's auditor and the administrator's auditor, whether or not they are the same firm.
197. The role of the employer's auditor is to report under "Forms A and B" as issued by the Registrar under section 20(7A) of the ORSO. Form A is the employer's auditor's statement issued to the administrator's auditor, and Form B is the statement on details of contributions. The employer's auditor is advised to refer to the Guidelines issued by the Registrar on the preparation of the Statement of the Employer's Auditor under section 20(7A) of the ORSO ("Registrar's Guidelines") for guidance.
198. The primary responsibility for completing Form B lies with the employer although in practice it is often completed by the administrator or with assistance from the administrator. Therefore, the employer's auditor would allow the employer to make amendments on the Form B prepared by the administrator if the information contained therein is not correct. Before carrying out any work on Form B, the employer's auditor would ensure that Form B is signed by the employer, or where Form B is signed by the administrator, that it is counter-signed by the employer.
199. The responsibility of the employer's auditor is to complete Form A which is addressed to the administrator's auditor and includes an opinion as to whether proper accounts and records have been kept in relation to contributions and whether Form B is in accordance with the books and records of the employer.

200. As the employer's auditor's work in relation to Forms A and B is usually not within the scope of a normal statutory audit of the financial statements of the employer, the employer's auditor would agree the terms of this engagement in writing with the employer.
201. Where the employer's auditor is not the statutory auditor for the annual audit of the financial statements of the employer, under paragraph 440.10 of the Code of Ethics for Professional Accountants under section 440 "Changes in a professional appointment", the employer's auditor is required to notify the statutory auditor of the work he is undertaking. This notification need not be given if the client advances a valid reason against it. The employer's auditor has the right to expect full co-operation of the statutory auditor in carrying out his assignment.
202. For a scheme that covers more than one relevant employer, the employer's auditor would set out in the engagement letter which relevant employers' Form B will be examined by him.

Procedures performed by the employer's auditor

203. The objective of the employer's auditor giving such an opinion in Form A is to provide the administrator's auditor with reliable audit evidence regarding contributions paid and payable for the financial year of the scheme.
204. The administrator's auditor is responsible for expressing an opinion on the financial statements of the scheme. Among other things, the administrator's auditor is required to report whether proper accounts and records have been kept; whether contributions have been made in accordance with the terms of the scheme and; for defined benefit schemes, whether the relevant undertaking has been complied with in respect of the financial year of the scheme.
205. It is therefore important that the employer's auditor plans and performs appropriate and sufficient procedures on Form B to justify his opinion given in Form A. This opinion provides an important part of the audit evidence required by the administrator's auditor in forming his opinion on the financial statements of the scheme.
206. In considering the nature and extent of procedures necessary, the employer's auditor would have regard to a number of factors, including:
- a. whether the financial year end of the scheme is the same as the financial year end of the employer;
 - b. whether the financial statements of the employer have been or are required to be audited;
 - c. whether the auditor's report on the employer's financial statements was qualified or unqualified;
 - d. the extent and nature of audit work performed on payroll and personnel records during the financial statement audit of the employer and the results of such audit work; and
 - e. the employer's auditor's general knowledge of the employer's business, internal controls and reliability of records.
207. Where the scheme is a defined benefit scheme, the employer's auditor would also have regard to the latest actuarial certificate and funding recommendations for the scheme as well as the "relevant undertaking" made by the employer to contribute to the scheme's funds in accordance with the actuary's recommendations. In such circumstances, the employer's auditor would pay particular attention to the column on Form B headed "percentage of payroll" under "Ordinary contributions from relevant employer".

Dates of receipt and payment of contributions

208. Where the date of receipt of a contribution by the administrator as shown on Form B differs by more than 14 calendar days from the date of payment as recorded in the employer's records, paragraph 23 of the Registrar's Guidelines requires that the opinion in Form A should be qualified in this respect and details of such differences should be provided in Form A.
209. The primary purpose of this qualification of opinion is to alert the administrator's auditor to the possibility of errors or irregularities arising which result in undue delay of contributions being credited to the scheme for the benefit of members. In determining what represents the "date of payment as recorded in the employer's records", the employer's auditor would have regard to the accounting system of the employer. The appropriate date may be determined from different records of the employer, depending upon the accounting system, but should usually represent the date of the cheque or other form of payment made by the employer in respect of the payment of contributions to the administrator.
210. For a scheme which the members or a class of members and their employers are exempted under section 5 of the MPFSO, the employer must pay all contributions to the scheme in respect of a "relevant" period by the due date. The term "relevant period" means each period in respect of which contributions are required to be paid. The due date by which employer contributions are required to have been paid to the scheme is:
- a. if the contribution requirements of a relevant scheme have specified the date on which the relevant employer is to pay a contribution, the due date for that contribution shall be the date so specified.
 - b. if the contribution requirements of a relevant scheme have not specified the date on which the relevant employer is to pay a contribution, the due date for the contribution for each relevant period shall be:
 - i. a day within a month next following the expiration of the relevant period as specified in a statement sent by the employer to the designated person; or
 - ii. if not so specified, the tenth day after the relevant period.

Such required date of payment should not be confused with the payroll date, although in some cases the contribution payment may be tied to the payroll date.

211. Where an employer fails to comply with its obligation to pay contributions by the due date the administrator is obliged to issue a written notice to the employer requiring the employer to pay the outstanding contributions within 30 days of the date of the notice. Such notice must be sent to the employer as soon as practicable after the administrator becomes aware of the failure by the employer to pay contributions by the due date.
212. Where the employer, despite the reminder from the administrator, still fails to pay the contributions which are in arrears the administrator is then obliged to notify the MPFA which, in turn, has the power to issue various payment notices to the employer and impose surcharges and financial penalties on the employer.

Opinion by the employer's auditor (Form A)

213. The employer's auditor is required to express his opinion in the general format set out in Form A. It is important that in expressing his opinion on whether proper accounts and records have been kept in relation to contributions, the employer's auditor indicates clearly whether or not the opinion is qualified, and if it is, precisely what the qualification(s) relate to. Similarly, in expressing his opinion on whether Form B is in accordance with the books and records of the relevant employer, the employer's auditor indicates whether or not the opinion is qualified, and if it is, the details of the exceptions identified. The employer's auditor would need to exercise professional judgement in deciding whether to include all or merely material exceptions identified by him in Form A.

214. The employer's auditor may find it desirable to reproduce Form A on the auditor's own letterheads. This is in order, provided that the contents of Form A conform to those specified in the Registrar's Guidelines. The template of Form A is included in Appendix 2 to this PN.
215. The employer's auditor's work on Form B is essentially an extension of a payroll audit. Therefore in forming an opinion in Form A in respect of whether proper accounts and records have been kept in relation to contributions, the employer's auditor considers whether the payroll and contribution details stated in Form B agree to the books kept by the employer. In addition, the employer's auditor considers whether sufficient personnel records have been kept in respect of each employee. Such personnel records may include the name of the employee, employment letter or contract, age, salary history, date of commencement of employment and date of joining the scheme, etc.

MPFA may require certain reports to be prepared by the auditor under section 32 of the ORSO

216. Under section 32 of the ORSO, the MPFA may under certain conditions require the administrator to cause an auditor approved by the MPFA to prepare a report on any matters specified in a written notice from the MPFA, and to supply the report to the MPFA. Such additional reports would constitute a separate appointment from that as the auditor of the financial statements of the scheme. Accordingly, any auditor appointed under these circumstances would agree the terms of this engagement in writing with the administrator.

APPENDIX 1

Example 1 - auditor's report on the financial statements of a MPF scheme - unqualified opinion

INDEPENDENT AUDITOR'S REPORT³ TO THE TRUSTEE OF XYZ SCHEME

Report on the Financial Statements

We have audited the financial statements of XYZ Scheme ("the Scheme") set out on pages to, which comprise the statement of net assets available for benefits as at [*year end date*], and the statement of changes in net assets available for benefits and [cash flow statement][statement of cash flows]⁴ for the year then ended, and a summary of significant accounting policies and other explanatory information.

Trustee's Responsibility for the Financial Statements

The trustee is 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 is responsible for ensuring that the financial statements have been properly prepared in accordance with sections 80, 81, 83 and 84 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), and for such internal control as the trustee determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit⁵. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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. In addition, we are required to assess whether the financial statements of the Scheme have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 and 84 of the General Regulation.

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 Scheme'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 Scheme's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the trustee, 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.

³ The auditor's report may be tailored to include reporting for constituent funds of the Scheme.

⁴ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

⁵ 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".

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Scheme as at *[year end date]*, and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

Report on matters under the Mandatory Provident Fund Schemes (General) Regulation

- a. In our opinion, the financial statements have been properly prepared, in all material respects, in accordance with sections 80, 81, 83 and 84 of the General Regulation.
- b. We have obtained all the information and explanations which, to the best of our knowledge and belief, are necessary for the purpose of our audit.

ABC & Co.

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

[Auditor's address]

Date of the auditor's report

**Example 2 - auditor's report on a MPF scheme's
compliance with certain requirements of the
Mandatory Provident Fund Schemes Ordinance and the
Mandatory Provident Fund Schemes (General) Regulation
- unqualified conclusion**

COMPLIANCE REPORT BY THE AUDITOR TO THE TRUSTEE OF XYZ SCHEME

We have audited the financial statements of XYZ Scheme ("the Scheme") for the year ended [*year end date*] in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated [*insert date here*].

Pursuant to section 102 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we are required to report whether the Scheme complied with certain requirements of the Mandatory Provident Fund Schemes Ordinance ("MPFSO") and the General Regulation.

Trustee's Responsibility

The General Regulation requires the trustee to ensure that:

- a. proper accounting and other records are kept in respect of the constituent funds of the Scheme, the Scheme assets and all financial transactions entered into in relation to the Scheme;
- b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation are complied with; and
- c. the Scheme assets are not subject to any encumbrance, otherwise than as permitted by the General Regulation.

Auditor's Responsibility

It is our responsibility to report on the Scheme's compliance with the above requirements based on the results of the procedures performed by us.⁶

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Scheme's compliance with the above requirements.

⁶ 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".

Conclusion

Based on the foregoing:

1. in our opinion:
 - a. proper accounting and other records have been kept during the year ended *[year end date]* in respect of the constituent funds of the Scheme, the Scheme assets and all financial transactions entered into in relation to the Scheme; and
 - b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 and Part X of, and Schedule 1 to, the General Regulation have been complied with, in all material respects, as at *[year end date]*, *[.....]*⁺ and *[.....]*^{*}; and
2. as at *[year end date]*, the Scheme assets were not subject to any encumbrance, otherwise than as permitted by the General Regulation.

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

* *insert 2 other dates in the year selected by the auditor for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than 3 months.*

**Example 3 - auditor's report on an applicant trustee's compliance
with prescribed capital adequacy requirements
pursuant to section 18 of the Mandatory Provident
Fund Schemes (General) Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO THE DIRECTORS OF XYZ LIMITED ("the Company")
PURSUANT TO SECTION 18 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 18 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to report on the Company's compliance with prescribed capital adequacy requirements.

Directors' Responsibility

Under the General Regulation, the directors are responsible for the Company's compliance with prescribed capital adequacy requirements.

Auditor's Responsibility

It is our responsibility to report on the Company's compliance based on the results of the procedures performed by us.⁷

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 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants. We have performed such procedures as we considered necessary for the purpose of reporting on the Company's compliance with prescribed capital adequacy requirements.

Conclusion

Based on the foregoing, in our opinion the Company has complied, in all material respects, with prescribed capital adequacy requirements as set out in section 11[(2)/(3)] of the General Regulation as at *[insert date here]*.

Use of this report

This report is intended solely for submission by the Company to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

⁷ 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 date agreed between the Company and the Mandatory Provident Fund Schemes Authority.*

**Example 4 - auditor's report on the trustee's compliance
with prescribed capital adequacy requirements
pursuant to section 115 of the Mandatory Provident
Fund Schemes (General) Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO XYZ TRUSTEE ("the Trustee")
PURSUANT TO SECTION 115 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 115 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to report on the Trustee's compliance with prescribed capital adequacy requirements.

Management's Responsibility

Under the General Regulation, management is responsible for the Trustee's compliance with prescribed capital adequacy requirements.

Auditor's Responsibility

It is our responsibility to report on the Trustee's compliance based on the results of the procedures performed by us.⁸

Basis of conclusion

We have audited the financial statements of the Trustee for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated *[insert date here]*.

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such additional procedures as we considered necessary for the purpose of reporting on the Trustee's compliance with prescribed capital adequacy requirements.

Conclusion

Based on the foregoing, in our opinion the Trustee has complied, in all material respects, with prescribed capital adequacy requirements as set out in section 11[(2)/(3)] of the General Regulation as at *[year end date]*, *[.....]* and *[.....]* *.

⁸ 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".

* *insert 2 other dates in the year selected by the auditor for performing procedures on checking compliance and such selected dates must be at least 3 months apart or such a shorter period the MPFA may allow.*

Note: In practice, section 115 (5) of the General Regulation imposes a six month deadline for the submission of this report to the trustee in order that the trustee can comply with section 114 (1) of the General Regulation - submission of the trustee's and auditor's report to the MPFA.

Use of this report

This report is intended solely for submission by the Trustee to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Date *[see note below]*

Example 5 - report by the auditor of a service provider for submission to the trustee pursuant to section 74(5)(b) of the Mandatory Provident Fund Schemes (General) Regulation

**INDEPENDENT AUDITOR'S REPORT
TO THE DIRECTORS OF XYZ LIMITED
PURSUANT TO SECTION 74(5)(b) OF THE MANDATORY PROVIDENT FUND SCHEMES
(GENERAL) REGULATION**

Pursuant to section 74(5)(b) of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to issue a report, in respect of the Service Agreements made between XYZ Limited ("the Company") and ABC Trustee dated *[insert date here]* ("Service Agreements").

Directors' Responsibility

Under the General Regulation, ABC Trustee requires the Company to submit to it a report of any material event and an annual report that complies with section 74(5) of the General Regulation. The directors of the Company are responsible for complying with the requirement of ABC Trustee in submitting the abovementioned reports to it.

Auditor's Responsibility

It is our responsibility to issue a report stating whether or not, in our normal course of duties as the auditor of the Company⁹, we have become aware of:

1. any failure of the Company to comply with the Company's obligations under the Service Agreements; and
2. any false declaration made by the Company to ABC Trustee or any other person.

Basis of conclusion

We have audited the financial statements of the Company for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("the HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated *[insert date here]*. The objective of the audit of the financial statements of the Company is to enable us to express an opinion on whether such financial statements give a true and fair view of the state financial position of the Company's ~~affairs~~ as at *[year end date]* and of its financial performance ~~[profit/loss]~~ and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared ~~in compliance~~ in accordance with the Hong Kong Companies Ordinance.

In preparing this report, we have also considered the guidance contained in Practice Note 860.1 "The Audit of Retirement Schemes" issued by the HKICPA.

In relation to our conclusion below, we are not required to perform any procedures in addition to the normal course of audit to search for instances of non compliance with obligations under the Service Agreements or any false declarations made to ABC Trustee or any other person.

⁹ 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".

Conclusion

Based on the foregoing, nothing has come to our attention during the course of our audit of the financial statements of the Company for the year ended *[year end date]* that causes us to believe that the Company:

1. failed to comply with its obligations under the Service Agreements; and
2. made any false declaration to ABC Trustee or any other person.

Use of this report

This report is intended solely for submission by the Company to ABC Trustee as required under section 74(1) of the General Regulation and is not intended to be, and should not be, used by anyone for any other purpose.

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

**Example 6 - auditor's report on the review of the trustee's report on
control objectives and internal control measures
pursuant to section 113 of the Mandatory Provident Fund Schemes (General)
Regulation - unqualified conclusion**

**INDEPENDENT AUDITOR'S REPORT
TO XYZ TRUSTEE
PURSUANT TO SECTION 113 OF THE MANDATORY PROVIDENT FUND SCHEMES (GENERAL)
REGULATION**

Pursuant to section 113 of the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), we have been requested to review a report on control objectives and internal control measures dated *[insert date here]* ("Trustee's Report") which is required to be prepared by you as trustee under section 112 of the General Regulation.

Scope

This report covers our review of the Trustee's Report on the control objectives and internal control measures of XYZ Trustee applicable to the approved Mandatory Provident Fund Schemes for which the trustee is XYZ Trustee ("the Schemes"), and does not extend to any other control objectives or internal control measures of XYZ Trustee.

Trustee's Responsibility

Under the General Regulation, XYZ Trustee is responsible for:

1. ensuring that control objectives, as stated under section 39 of the General Regulation, are established and maintained with respect to the Schemes by ensuring that:
 - a. the assets of the Schemes are safeguarded in the interests of members of the Schemes;
 - b. the guidelines made by the Mandatory Provident Fund Schemes Authority ("MPFA") under section 28 of the Mandatory Provident Fund Schemes Ordinance with respect to forbidden investment practices are not contravened;
 - c. the limitations and prohibitions imposed under the General Regulation with respect to the investment of the funds of the Schemes in restricted investments are complied with;
 - d. the requirements of section 37(2) of the General Regulation with respect to capital preservation fund, section 51 of the General Regulation with respect to repurchase agreements, section 52 of the General Regulation with respect to stock lending and Schedule 1 to the General Regulation with respect to permissible investments are complied with in relation to the Schemes; and
 - e. the funds of the Schemes and the assets of the Schemes are, except as permitted by the General Regulation, kept separate from those of the participating employers, XYZ Trustee and the service providers and other persons appointed or engaged for the purposes of the Schemes;
2. establishing and maintaining the following internal control measures and procedures for achieving the above control objectives:
 - a. monitoring investments to ensure that the control objectives referred to in paragraphs 1(b), (c) and (d) above are achieved;
 - b. monitoring the funds of the Schemes and the assets of the Schemes to ensure the objective referred to in paragraph 1(e) above is achieved, so that the funds of the

Schemes and the assets of the Schemes are kept separate from those of the participating employers, XYZ Trustee and any other persons (such as service providers); and

- c. ensuring the accuracy of statements, returns and reports required to be lodged with the MPFA; and
3. implementing the recommended measures outlined in the MPFA Guidelines II.6 "Guidelines on Internal Control Report for each Registered Scheme" ("MPFA Guidelines II.6").

Auditor's Responsibility

It is our responsibility to review the Trustee's Report and report in writing to XYZ Trustee on the review.¹⁰

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 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants. Our work was based upon obtaining an understanding of the control procedures in operation by enquiry of management and review of documents supplied to us.

In accordance with the MPFA Guidelines II.6, we are not required to test and ascertain whether the control objectives and internal control measures as described on pages [] to [] were actually implemented during the year ended *[year end date]*. Our work was limited to ensuring whether relevant control objectives and internal control measures were designed by XYZ Trustee for meeting each of the requirements specified in the General Regulation and the MPFA Guidelines II.6.

We have not performed an assessment of the adequacy or completeness of the control objectives in relation to the risks they are designed to address. Our work was limited to the objectives specified in the General Regulation and our conclusion relates solely to reporting that XYZ Trustee has designed control objectives and internal control measures in line with those recommended in the MPFA Guidelines II.6.

Inherent limitations

Internal control measures 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:

1. appropriate control objectives were established and maintained for the Schemes during the year ended *[year end date]*;
2. effective internal control measures were established and maintained for the purpose of achieving those objectives during the year ended *[year end date]*; and
3. those internal control measures were likely to have been sufficiently effective, in all material respects, to provide a reasonable assurance that the control objectives established and maintained for the Schemes would be achieved if those measures were fully and properly implemented.

¹⁰ 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 RETIREMENT SCHEMES

During the course of our engagement, we did not become aware of any shortcomings in the internal control measures that could materially affect the operation of the Schemes (including their financial position) or the financial interests of members of the Schemes during the year ended *[year end date]*.

OR

During the course of our engagement, we became aware of the following shortcomings in the internal control measures that could materially affect the operation of the Schemes (including their financial position) or the financial interests of members of the Schemes during the year ended *[year end date]*:

-
-
-
-
-

Use of this report

This report is intended solely for submission by XYZ Trustee to the MPFA pursuant to section 112(3) of the General Regulation, and is not intended to be, and should not be, used by anyone for any other purpose.

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

**Example 7 - auditor's report on the
financial statements of an ORSO scheme - unqualified opinion**

**INDEPENDENT AUDITOR'S REPORT
TO THE ADMINISTRATOR¹¹ OF XYZ SCHEME**

[Report on the Financial Statements]¹²

We have audited the financial statements of XYZ Scheme ("the Scheme") set out on pages to, which comprise the statement of net assets available for benefits as at *[year end date]*, and the statement of changes in net assets available for benefits and *[cash flow statement]**[statement of cash flows]*¹³ for the year then ended, and a summary of significant accounting policies and other explanatory information.

Administrator's Responsibility for the Financial Statements

The administrator is 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 provisions of the Occupational Retirement Schemes Ordinance, and for such internal control as the administrator determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit¹⁴. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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.

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 Scheme'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 Scheme's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the administrator, 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.

¹¹ The term "administrator" is used in this Practice Note to refer to the trustee if an ORSO scheme is governed by a trust or the insurer if an ORSO scheme is the subject of or regulated by an insurance arrangement. The auditor's report is addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditor's report is addressed to the administrator.

¹² The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹³ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

¹⁴ 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".

Opinion

In our opinion, the financial statements give a true and fair view of the disposition of the assets and liabilities of the Scheme as at *[year end date]* and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

[Report on matters under section 20(3)(c) of the Hong Kong Occupational Retirement Schemes Ordinance]¹²

[The auditor shall state in the auditor's report such other information as the MPFA may specify in the guidelines issued by it. The auditor is required under the ORSO (section 20(3)(c)) to report by exception the following limitations on the scope of the work:

- a. access to the employer's books and records has been denied; or*
- b. the auditor is unable to obtain all the information and explanations which, to the best of the knowledge and belief, are necessary for the purpose of the audit.]*

ABC & Co.

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

[Auditor's address]

Date of Auditor's Report

**Example 8 - auditor's report on an ORSO scheme's
compliance with certain requirements of the
Occupational Retirement Schemes Ordinance - unqualified conclusion**

**COMPLIANCE REPORT BY THE AUDITOR
TO THE ADMINISTRATOR¹⁵ OF XYZ SCHEME**

We have audited the financial statements of XYZ Scheme ("the Scheme") for the year ended [*year end date*] in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued [an unqualified/a qualified] auditor's report thereon dated [*insert date here*].

Pursuant to section 20 of the Occupational Retirement Schemes Ordinance ("ORSO"), we are required to report whether the Scheme complied with certain requirements of the ORSO.

Administrator's Responsibility

The ORSO requires the administrator to ensure that:

- a. proper accounts and records are kept as regards all assets, liabilities and financial transactions of the Scheme;

[*For a defined benefit scheme only*]

- b. the relevant undertaking, as defined under section 20(4) of the ORSO¹⁶, is complied with;

OR

[*For a defined contribution scheme only*]

- b. contributions are made in accordance with the terms of the Scheme;
- c. the assets of the Scheme are not subject to any assignment, charge,¹⁷ pledge or other encumbrance except for those specified in section 20(3)(b)(iii) of the ORSO¹⁷; and
- d. the requirements of section 27(2) of the ORSO¹⁸ are complied with.

Auditor's Responsibility

It is our responsibility to report on the Scheme's compliance with the above requirements based on the results of the procedures performed by us.¹⁹

¹⁵ The term "administrator" is used to refer to the trustee if an ORSO scheme is governed by a trust or the insurer if an ORSO scheme is the subject of or regulated by an insurance arrangement. The auditors' report is addressed in accordance with the trust deed or scheme rules. Where the deed is silent, the auditors' report is addressed to the administrator.

¹⁶ "relevant undertaking" is defined by section 20(4) and Schedule 2 Parts 1 and 2 paragraph 6 of the ORSO as a written undertaking by the relevant employer of the scheme (i.e. the employer who provides the employment which entitles or enables the employee to be a member of the scheme) to the administrator of the scheme to contribute to the scheme's fund in accordance with recommendations made by the actuary in the actuarial certificate issued as regards a particular registered scheme. Where more than one actuarial certificate has been issued, the undertaking referred to is the one in the most recent of those certificate which is applicable to the financial period under review.

¹⁷ *The exceptions stated in section 20(3)(b)(iii) of the ORSO are as follows:*

- a. *the trust (if any) governing the scheme;*
- b. *any charge or pledge created for the purposes of securing loans necessary for meeting the liabilities of the scheme; and*
- c. *any option to acquire for valuable consideration any interest in the assets of the scheme granted in the normal course of business.*

¹⁸ *Section 27(2) of the ORSO stipulates the investment restrictions.*

¹⁹ 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".

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Scheme's compliance with the above requirements.

Conclusion

Based on the foregoing, in our opinion:

1. proper accounts and records have been kept during the year ended [year end date] as regards all assets, liabilities and financial transactions of the Scheme;

[For a defined benefit scheme only]

2. the relevant undertaking, as defined under section 20(4) of the ORSO, has been complied with during the year ended [year end date];

OR

[For a defined contribution scheme only]

2. contributions have been made in accordance with the terms of the Scheme during the year ended [year end date]; and

[If there is a shortfall]

at [net assets statement date] there was a shortfall amounting to HK\$..... between the Scheme's assets and the Scheme's aggregate vested liability;

OR

[If there is no shortfall]

at [net assets statement date] there was no shortfall between the Scheme's assets and the Scheme's aggregate vested liability;

3. at [net assets statement date] the assets of the Scheme were not subject to any assignment, charge, pledge or other encumbrance except for those specified in section 20(3)(b)(iii) of the ORSO; and

4. at [net assets statement date], [.....] and [.....]²⁰ the requirements of section 27(2) of the ORSO have been complied with.

Use of this report

This report is intended solely for submission by the administrator to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

²⁰ Insert two other dates in the year selected by the auditors for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than three months.

Example 9 - auditor's report on the financial statements of an APIF - unqualified opinion

INDEPENDENT AUDITOR'S REPORT TO THE [TRUSTEE][INSURER] OF XYZ FUND

Report on the Financial Statements

We have audited the financial statements of XYZ Fund ("the Fund") set out on pages to, which comprise the statement of net assets attributable to [fundholders][unitholders] as at [*year end date*], and the statement of comprehensive income, the statement of changes in net assets attributable to [fundholders][unitholders] and [cash flow statement][statement of cash flows]²¹ for the year then ended, and a summary of significant accounting policies and other explanatory information.

[[Manager's and] [Trustee's] [Insurer's] Responsibility for the Financial Statements

The [Manager and the] [Trustee][Insurer] of the Fund [are][is] 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 are responsible for ensuring that the financial statements have been properly prepared in accordance with the relevant disclosure provisions of the constitutive documents of the Fund ("the Constitutive Documents"), the Mandatory Provident Fund Schemes Ordinance ("the MPFSO"), the Mandatory Provident Fund Schemes (General) Regulation ("the General Regulation"), the Code on MPF Investment Funds ("the MPF Code"), and Guidelines II.5 issued by the Mandatory Provident Fund Schemes Authority ("the MPFA") [and the Code on Unit Trusts and Mutual Funds ("the Code") issued by the Hong Kong Securities and Futures Commission ("the SFC")]²², and for such internal control as the [manager and the] [trustee][insurer] determine[s] is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit²³. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" 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. We are also required to assess whether the financial statements of the Fund have been properly prepared, in all material respects, in accordance with the relevant disclosure provisions of the constitutive documents of the Fund, the MPFSO, the General Regulation, the MPF Code and Guidelines II.5 issued by the MPFA [and the Code issued by the SFC]²².

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 judgement, 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 Fund'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 Fund's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the [manager and the] [trustee][insurer], as well as evaluating the overall presentation of the financial statements.

²¹ Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

²² Delete if the Fund is only approved by the MPFA but not authorized by the SFC under section 104(1) of the Securities and Futures Ordinance.

²³ 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".

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 financial position of the Fund as at *[year end date]*, and of its financial transactions and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

- (a) In our opinion, the financial statements have been properly prepared, in all material respects, in accordance with the relevant provisions of the constitutive documents of the Fund, the MPFSO, the General Regulation, the MPF Code and Guidelines II.5 issued by the MPFA [and the Code issued by the SFC]²²; and
- (b) We have obtained all the information and explanations which, to the best of our knowledge and belief, are necessary for the purpose of our audit.

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

Example 10 - auditor's report on an APIF's compliance with certain requirements of the Mandatory Provident Fund Schemes Ordinance, the Mandatory Provident Fund Schemes (General) Regulation and the Code on MPF Investment Funds - unqualified conclusion

COMPLIANCE REPORT BY THE AUDITOR TO THE [TRUSTEE][INSURER] OF XYZ FUND

We have audited the financial statements of XYZ Fund ("the Fund") for the year ended *[year end date]* in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 860.1 "The Audit of Retirement Schemes" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and have issued *[an unqualified/a qualified]* auditor's report thereon dated *[insert date here]*.

Pursuant to Guidelines II.5 and Code on MPF Investment Funds issued by the Mandatory Provident Fund Schemes Authority, we are required to report whether the Fund complied with certain requirements of the Mandatory Provident Fund Schemes Ordinance ("the MPFSO") and the Mandatory Provident Fund Schemes (General) Regulation ("General Regulation"), which are made applicable to the Fund through the Code on MPF Investment Funds.

[Manager and the] [Trustee][Insurer]'s Responsibility

The General Regulation requires the *[manager and the] [trustee][insurer]* to ensure that:

- a. proper accounting and other records are kept in respect of the Fund assets and all financial transactions entered into in relation to the Fund;
- b. the requirements specified in the guidelines made by the Mandatory Provident Fund Schemes Authority ("the MPFA") under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 of, and Schedule 1 to, the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds, are complied with; and
- c. the Fund assets are not subject to any encumbrance, otherwise than as permitted by section 65 of the General Regulation.

Auditor's Responsibility

It is our responsibility to report on the Fund's compliance with the above requirements based on the results of the procedures performed by us.²⁴

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 860.1 "The Audit of Retirement Schemes" issued by the HKICPA. We have performed such procedures as we considered necessary for the purpose of reporting on the Fund's compliance with the above requirements.

²⁴ 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".

Conclusion

Based on the foregoing:

1. in our opinion:
 - a. proper accounting and other records have been kept during the year ended *[year end date]* in respect of the Fund assets and all financial transactions entered into in relation to the Fund; and
 - b. the requirements specified in the guidelines made by the MPFA under section 28 of the MPFSO with respect to forbidden investment practices and the requirements of sections 37(2), 51 and 52 of, and Schedule 1 to, the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds, have been complied with, in all material respects, as at *[year end date]*, *[.....]*^{*} and *[.....]*^{*}.
2. as at *[year end date]*, the assets of the Fund were not subject to any encumbrance, otherwise than as permitted by section 65 of the General Regulation, which are made applicable to the Fund through the Code on MPF Investment Funds.

Use of this report

This report is intended solely for submission by the [manager and the] [trustee][insurer] to the Mandatory Provident Fund Schemes Authority and is not intended to be, and should not be, used by anyone for any other purpose.

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

* *insert 2 other dates in the year selected by the auditor for performing the procedures on checking compliance provided that the intervening period between such dates is not shorter than 3 months.*

APPENDIX 2

FORM - A

Occupational Retirement Schemes Ordinance (Cap. 426)
("the Ordinance")

The Employer's Auditor's Statement to the
Administrator's Auditor under section 20(7A) of the Ordinance

Name of the Relevant Employer: _____
(“the relevant employer”)

Name of the Occupational
Retirement Scheme: _____
(“the Scheme”)

Registration No. of the Scheme: _____

Types of Scheme (indicate by a tick in the appropriate boxes):-

- Defined contribution
- Defined benefit
- Governed by trust
- Subject of or regulated by insurance arrangement
- Participating in a pooling agreement:-
Yes
No

If “Yes”, name of pooling agreement: _____

- Participating in a group scheme
(see Paragraph 10 of Registrar's Guidelines):-
Yes
No

If “Yes”, name of representative employer: _____

Name of employer's auditor: _____

Name of administrator's auditor: _____

Address of administrator's auditor: _____

THE AUDIT OF RETIREMENT SCHEMES

*I/We, _____, of
(name of employer's auditor)

(address of employer's auditor)

being the employer's auditor duly appointed under section 20(7B)(a) of the Ordinance, hereby state as follows:-

1. *I/We have completed procedures on the Statement on Details of Contributions (Form B attached) for the financial year ended _____ in so far as they relate to the Scheme, having regard to the guidelines issued by the Registrar and in accordance with the pronouncements issued by Hong Kong Institute of Certified Public Accountants.
2. Based on these procedures in *my/our opinion:-
 - (a) proper accounts and records *have/have not been kept in relation to contributions; and
 - (b) the Statement on Details of Contributions is in accordance with the books and records of the relevant employer (*except as noted here-under):-

(Signed)
(Name of employer's auditor)

(Date)

(Place)

* Delete whichever is not applicable.

(This Form and the attached Form B should be returned directly to the administrator's auditor.)