

Alert

Updates on financial reporting and auditing



Issue 5 (December 2009)

Dear members,

Practice Note 820: The Audit of Licensed Corporations and Associated Entities of Intermediaries (PN 820)

1. In this Alert, we would like to remind practising members of guidance to good practice during the audit of licensed corporations and associated entities of intermediaries that is set out in PN 820
http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumell/pn820.pdf .
2. The Securities and Futures Ordinance (SFO) is designed to protect investors. Entities registered and regulated under the SFO must observe at all times its provisions, subsidiary legislation, codes and guidelines. Under the provisions of the SFO, regulated entities appoint practising members to carry out work that will result in the production of auditor's or other compliance reports. In accepting and performing such engagements, special considerations should be given to the provisions of the SFO that place specific responsibilities on regulated entities and their auditors.
3. PN 820 is specific to the audit of licensed corporations and associated entities of intermediaries. It has been developed to assist auditors obtain a sound understanding of the regulatory environment that their clients operate in, the audit risks involved in such engagements and the application of HKSA's to this specialized industry. The PN contains a number of recommended procedures that will help auditors conduct their audit effectively and arrive at an appropriate opinion.
4. The evidence that we have gained through practice review and other sources indicates that not all auditors of licensed corporations are thoroughly conversant with the guidance and recommended procedures of PN 820. Given the high profile nature of regulated clients, and the potential existence of client assets, we would urge members to understand and pay close attention to the rules and regulations set out in the SFO. If non-compliance by auditors is identified by the Securities and Futures Commission (SFC) in its role as regulator of licensed corporations, a complaint to the Institute is a likely consequence. This Alert highlights certain key areas which members should pay attention to in future audits.

Terms of engagement and management representations

5. Because of the special requirements imposed by the SFO, the auditor's engagement letter for regulated entities should, in addition to the basic requirements of HKSA 210 *Terms of Audit Engagements*, cover reporting requirements under the Securities and Futures (Accounts and Audit) Rules (the Rules) and in particular, the auditor's rights and duties to report directly to the SFC.
6. To address the nature and business of licensed corporations, the auditor should consider obtaining specific representations in addition to the standard representations set out in HKSA 580 *Management Representations*. Paragraph 68 of PN 820 contains examples of additional representations that may be relevant.

Procedures

7. In performing the audits of regulated entities, auditors should design and carry out audit procedures that address risks and other factors that are relevant for regulated entities but may not be present in the audit of clients in other industries or areas of business. Some of the recommended procedures set out in PN 820 that are at times overlooked are highlighted below.

The risk of fraud

8. Paragraphs 30 and 31 of PN 820 set out some factors that may be relevant in assessing the risk of fraud in regulated entities. Among these factors is the potential complexity of financial products, management and staff remuneration packages linked to profits or revenue and market volatility. Auditors should also be aware of SFC requirements for regulated entities to have adequate systems of internal control over client assets.

Understanding the entity and its environment

9. Assessment of how a computer information system environment affects the audit is especially relevant for audits of regulated entities due to high volumes of transactions and linkages to various third party systems that are typical of the industry. Without a detailed knowledge of the regulated entity's computer information system, it would be difficult for an auditor to demonstrate compliance with HKSA 300 *Planning an Audit of Financial Statements* and HKSA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
10. Auditors are also reminded of the need to consider systems of control when reporting on client assets in the areas set out below:
 - whether there are satisfactory arrangements for ensuring that standing authorities due for renewal are identified – paragraph 15a of Appendix 2 to PN 820;

- whether the closing aggregate market value for repledged securities collateral for each business day does not exceed 140% of its aggregate margin loan on the same date – paragraph 19(e)(i) of Appendix 2 to PN 820;
- whether client money has been held on trust for clients in one or more segregated bank accounts designated as a trust account or client account – paragraph 44 of Appendix 2 to PN 820; and
- whether there are adequate systems to ensure that all client money is paid in promptly – paragraph 45(g) of Appendix 2 to PN 820.

Circularisation of clients' account balances

11. The nature of regulated entities business is such that confirmation of clients' account balances is an important part of the audit process. The SFC has issued a list of matters which may be taken into account by the auditor when conducting a circularisation of clients' account balances which is set out in paragraph 27 of Appendix 2 to PN 820. This provides good practical advice on conducting an effective circularisation including timing, the need for the auditor to control the process and use of language that will be readily understood by clients of the regulated entity.

Compliance with laws and regulations

12. HKSA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* features prominently when conducting the audit of a regulated entity. The consequences of non-compliance with laws and regulations could seriously affect the ability of a regulated entity to continue in business. In particular auditors will need to understand and assess a regulated entity's high level procedures for complying with applicable codes and guidelines that is a prerequisite of obtaining a licence to operate in the appropriate field. Auditors should also consider how a regulated entity has developed and implemented policies and procedures to address the requirements of laws and regulations relating to money laundering.

Subsequent events

13. Subsequent events procedures should include review of correspondence with the SFC since the period end and making enquiries of management to determine whether any breaches of the law, codes and guidelines or other regulatory concerns have come to light since the period end.

Materiality for financial returns and compliance reports

14. Under section 3(1)(b) of the Rules, licensed corporations are required to submit financial returns (FRR) to the SFC. The auditor is required to give an opinion stating whether the FRR has been correctly compiled from the records of the licensed corporation, or if not correctly compiled, the nature and extent of the errors or omissions (compliance report).

15. Materiality is not recognised under the Rules and immaterial discrepancies or reclassifications cannot be ignored. It is not uncommon for auditors to identify discrepancies and reclassifications as a result of timing whereby the FRR is submitted shortly after the period end but the compliance report is not finalized until sometime later, often after completion of statutory accounts. If the FRR is not revised and resubmitted a qualified compliance report should be issued where discrepancies and reclassifications are identified, regardless of materiality.
16. Where the licensed corporation submits a revised FRR, the auditor should identify clearly in the compliance report which FRR the report is referring to. It should be the latest FRR submitted to the SFC prior to the date of the compliance report.

Coming event

17. As part of the programme to provide continuous guidance and support to members, the Institute, together with the SFC, will be holding a joint seminar in the evening of 19 January 2010 on the audit of licensed corporations. For more information, please see the attached link below:
http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/events/2009/OtherForum/f100119.pdf

Conclusion

18. Practising members are reminded of the importance of ensuring that adequate and relevant audit work is performed and documented before issuing any report. As the work done and the reports issued on licensed corporations relate to entities that deal with the investing public and are subject to scrutiny by the SFC, any audit failures are likely to result in considerable public exposure. PN 820 provides guidance to assist members engaged in the audit of licensed corporations plan, perform and document audit work that is adequate and relevant and meets the requirements of auditing standards and regulations.



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