



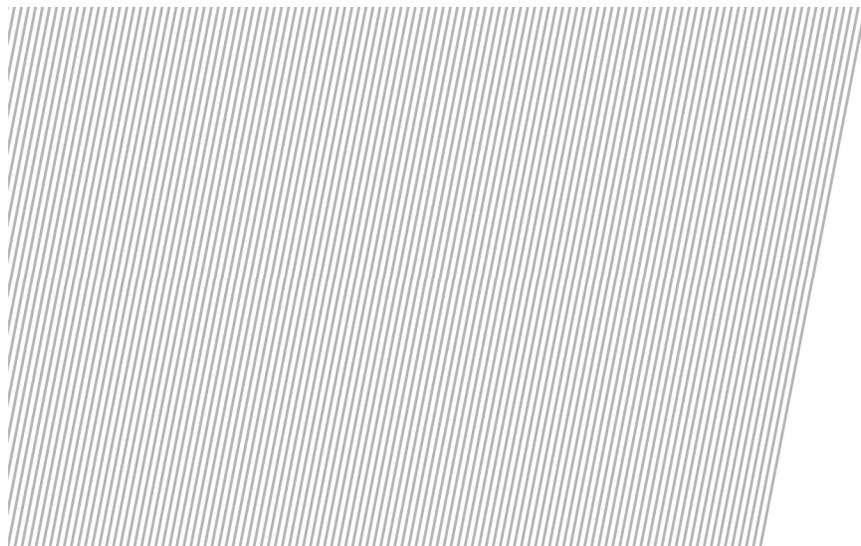
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Part II	The audit of financial statements
Part III	Auditor's reports under the Securities and Futures (Accounts and Audit) Rules
Part IV	Other reporting considerations
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Audit of licensed corporations and associated entities of intermediaries

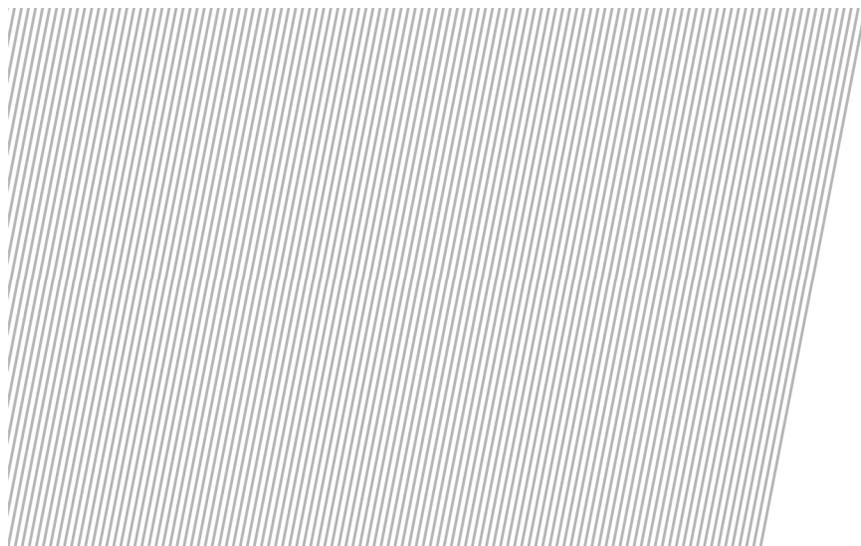
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Part I – General



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Part II – The audit of financial statements



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HKSA 240: The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

- ▶ PN details factors that may suggest risk of a material misstatement due to fraud
- ▶ Refer to SFC website.
- ▶ Importance of adequate systems of internal control.

HKSA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

Matters to consider:

Money laundering

Codes and Guidelines issued by the SFC

- ▶ Code of Conduct for Persons Licensed by or Registered with the SFC
- ▶ Management, Supervision and Internal Control Guidelines for persons licensed by or Registered with the SFC
- ▶ 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

HKSA 260: Communication of Audit Matters with Those Charged with Governance

Communications between auditors and the SFC
Covered in Part V of the PN

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Audit of licensed corporations and
associated entities of intermediaries

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HKSA 300: Planning an audit of financial statements HKSA 315: Understanding the entity and its environment and assessing the risks of material misstatement

Matters to consider:

Audit team must have sufficient knowledge

- ▶ Extended reporting responsibility on internal controls over client assets
- ▶ Must refer to SFC guideline “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

Key is “adequate”

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Audit of licensed corporations and
associated entities of intermediaries

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HKSA 300: Planning an audit of financial statements
HKSA 315: Understanding the entity and its environment and assessing the risks of material misstatement (continued)

Matters to consider:

Guidance is given in Appendix 2 of the PN:

- ▶ To ensure the regulated entity safeguard client assets
- ▶ To ensure client assets are protected from claims of creditors in the event of insolvency
- ▶ Any implications to the truth and fairness of financial statements should be considered if controls are found to be inadequate
- ▶ Guidance only, not intended to replace auditors' professional judgment

HKSA 320: Audit Materiality

Compliance report – no materiality concept

Audit questionnaire – need to report material breaches between FRR submitted and audited financial statements

HKSA 402: Audit considerations relating to entities using service organizations

Outsourcing : still need to ensure compliance with law, codes and guidelines

Includes review of service provider reports issued for the service providers

HKSA 505: External confirmations

- ▶ Strong audit evidence
- ▶ Include client assets
- ▶ Linked to fraud assessment and quality of internal controls
 - ▶ Hold mail accounts
 - ▶ Direct mail to address of management of staff accounts
 - ▶ Inactive and dormant accounts

HKSA 560 (Revised): Subsequent events

Review SFC correspondence after year end.

HKSA 570: Going concern

Assess possibility of regulatory action and falls / deficits in
liquid capital

HKSA 580: Management representations

In addition:

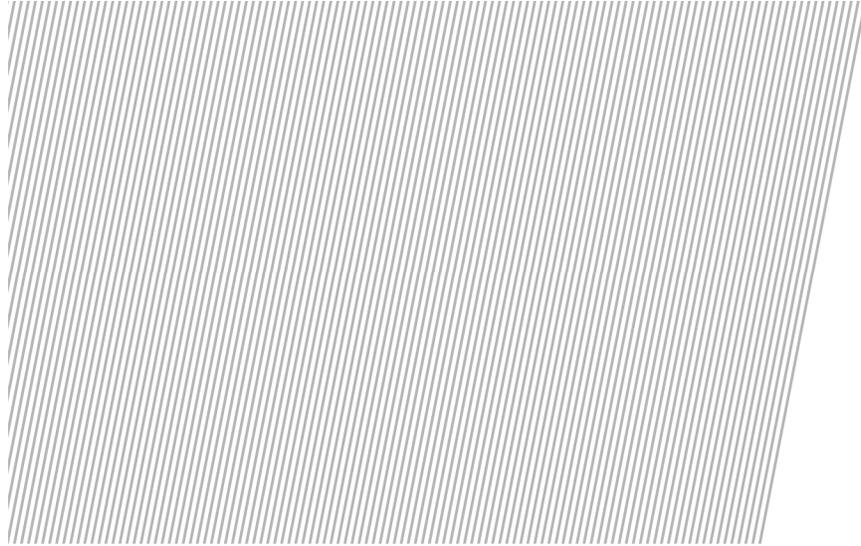
- ▶ Acknowledge management responsibilities re laws, codes, guidelines
- ▶ Confirm compliance
- ▶ Confirm all regulator correspondence made available
- ▶ Confirm all complaints have been drawn to the attention of the auditor

HKSA 720: Other information in documents containing audited financial statements

Matters to consider:

- ▶ To be applied on Account Disclosure Document for Licensed Corporation
- ▶ To report when there are any material misstatements or material inconsistencies with the financial statements in the Audit Questionnaire
- ▶ To be filed with the compliance report

Part III – Auditor’s reports under the Securities and Futures (Accounts and Audit) Rules



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Auditors reporting responsibilities

Two reports to be issued by auditors:

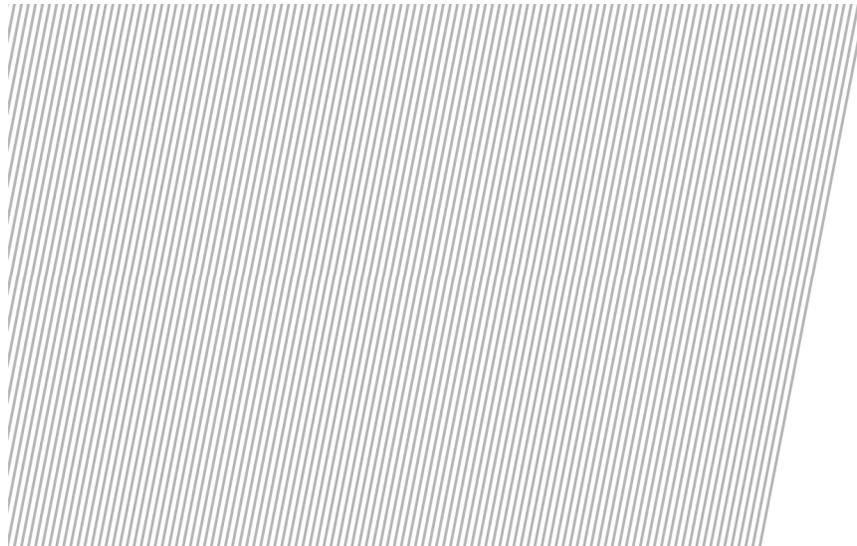
- ▶ Auditors’ report under the Companies Ordinance or the equivalent in other jurisdictions [and in accordance with Securities and Futures (Keeping of Records) Rules]
- ▶ Compliance Report
Audit Questionnaire
- ▶ Covered under “Other reporting considerations”

Auditors reporting responsibilities

Key points to focus on

- ▶ Remember: no materiality for compliance report
- ▶ If a qualified report is going to be issued there is a legal obligation to notify the SFC immediately not just when the report is issued
- ▶ Record keeping to enable audit
- ▶ Errors noted in the originally submitted FRR return
- ▶ No need to report on Compliance Report if revised FRR return is submitted

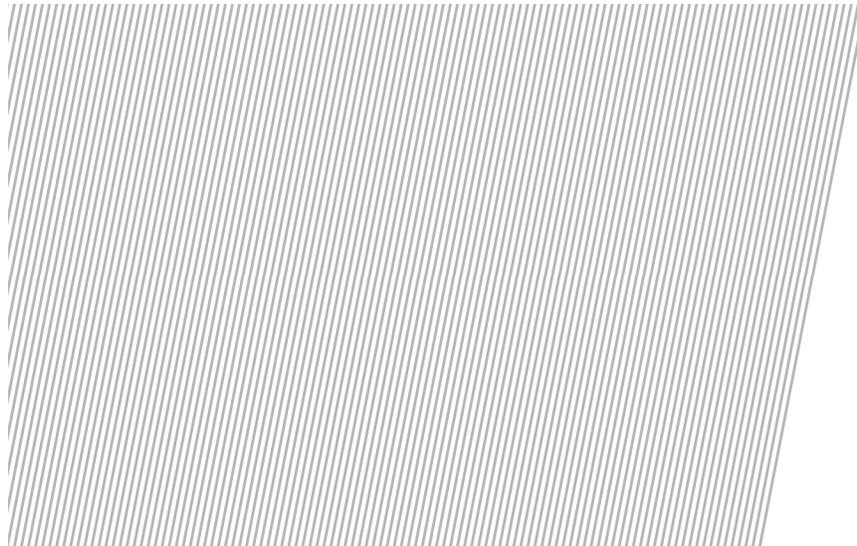
Part IV – Other reporting considerations



Audit questionnaire & Account Disclosure Document

- ▶ Provided to the SFC on a voluntary basis – Section 158 of SFO allows auditor to provide such information
- ▶ SFC does not expect auditor to extend work
- ▶ Account Disclosure Document – covered in consideration of HKSA 720
- ▶ Reconciliation (if required)
- ▶ Questions relating to confirmations and controls over client assets

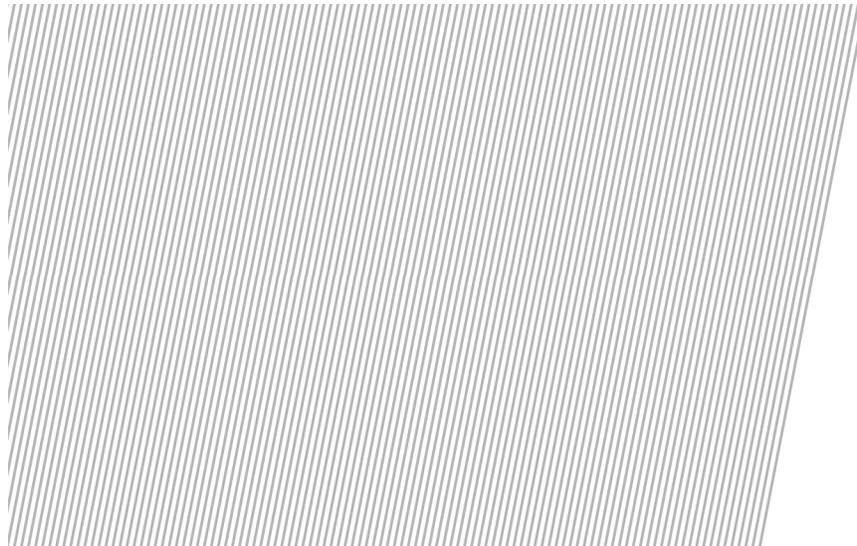
Part V – Communications between the auditor and the SFC



Communications between auditor and the SFC

- ▶ Section 157 – Auditor obligations to report to the SFC
 - ▶ As soon as reasonably practicable for qualification or adverse opinions
 - ▶ Resignation as auditor
- ▶ Section 158 – Protection for auditor to report to the SFC
- ▶ Section 378(3)(h) – Disclosure of Information by the SFC to auditor

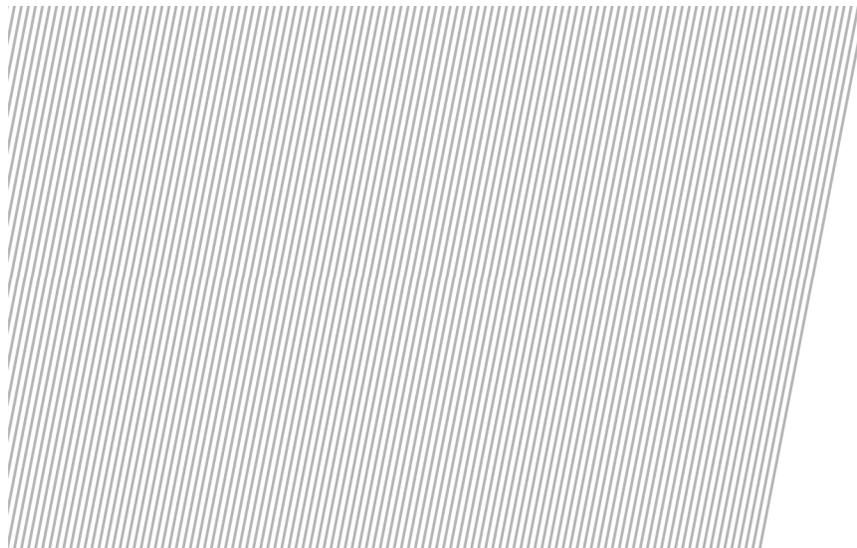
Appendix 1 – Examples of auditors' reports



Auditors Reports

- ▶ Example 1 - auditor's report on financial statements - regulated entity
- ▶ Example 2 - compliance report by the auditor - licensed corporation
- ▶ Example 3 - compliance report by the auditor - associated entity of intermediary

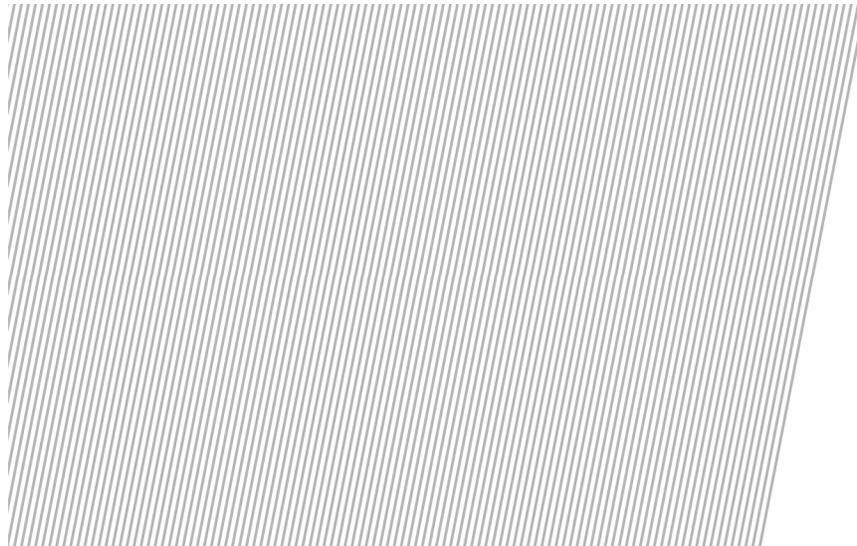
Appendix 2 – Client assets



Appendix 2 – Client assets

- ▶ Provides detailed guidance to auditor on work normally carried out to form an opinion on client assets – divided between client securities and client money
- ▶ Guidance provided on the performance of a circularization of clients account balances – see para 27(b), (c), (h) & (i).

Ad-hoc reviews

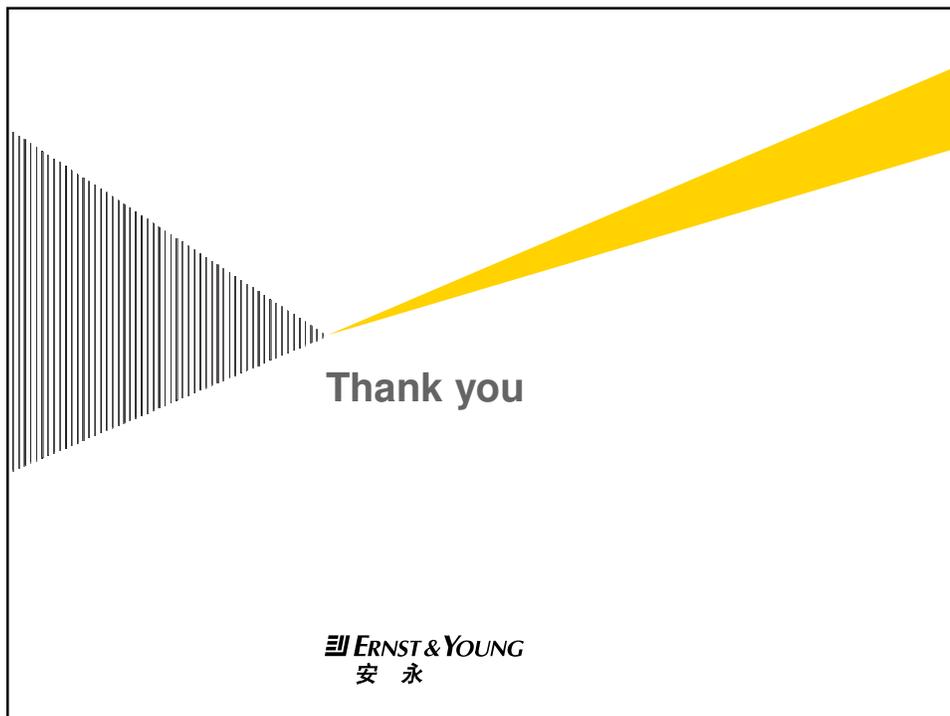


Ad-hoc reviews

Hong Kong Standard on Assurance Engagements 3000

- ▶ Agreeing on the Terms of the Engagement
- ▶ Planning and Performing the Engagement
- ▶ Preparing the Assurance Report

Other types of reporting



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SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Independent Control Reviews for Stockbrokers

19 January 2010

Mr Leo Lam, Director
Mr Frankie Fan, Senior Manager
Ms Erica Siu, Senior Manager

Intermediaries Supervision Department
Securities and Futures Commission

Agenda

1. Introduction
2. Independent control reviews for stockbrokers
3. Annual assessment on sponsor firms



Statistics of Enforcement Action against licensees

	2009	2008
Misappropriation of client assets	1	1
Misuse of client assets	1	1
Control deficiencies and breaches	15	7
Sub-Total (LCs)	17	9
Individual Licensees	32	36
Total	49	45

Published in Enforcement News up to Dec 2009



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Misappropriation of clients' assets

During the investigation of a case involving misappropriation of client assets by an employee of a licensed firm, the SFC found a number of deficiencies in the licensed firm's internal control system, including failing to:

- segregate its front and back office functions
- ensure that the issuing process of trading documents, including client statements and contract notes, is properly protected against tampering and abuse by unauthorised staff, and
- ensure adequate and diligent supervision of its staff



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Serious internal control deficiencies related to brokerage business

The SFC found serious internal control deficiencies in a licensed firm, including failure to:

- provide contract notes and monthly statements to its clients within the prescribed time
- maintain a correct client stock record
- ensure that proper written authorisations for hold-mail arrangements were obtained
- segregate duties of the front and back office staff
- prevent one client's securities from being used to settle another client's sale transaction, and
- ensure adequate and diligent supervision of its staff



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Implications to auditors

- Assessment of control environment and fraud risks
- Financial impact arising from client claims
- Implication to the licensed firm's reputation, licensing status and going concern



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General objectives of ICR of licensed corporation

- To review the adequacy of internal control, compliance and risk management systems and procedures of licensed firm identified to have significant control failures or breaches
- To improve the licensed firm's internal control system and ability to ensure compliance with applicable laws and regulatory requirements through implementation of recommended measures suggested by the reviewing accountants



Benefits of ICR

- Independent evaluation of the licensed firm's control environment, procedures and compliance
- Mitigation of risk of future breaches through identifying control deficiencies and non-compliance and taking prompt remedial action
- Demonstration of the licensed firm's commitment to ensure compliance and proper controls
- Benefit of recommendation of contemporary best practices by experienced consultants



Agenda

- 1. Introduction**
- 2. Independent control reviews for stockbrokers**
- 3. Annual assessment on sponsor firms**



Independent control reviews for stockbrokers

- **Scope of review**
- **Tips for conducting a successful review**



Scope of review

- **Varies with the underlying problem / deficiencies triggering the need for the review, e.g.**
 - Misappropriation of clients' monies / securities
 - Frauds
 - False client accounts
 - Breach of rules / regulations
 - IT system failure, etc.



Example – Scope of review for a misappropriation case

Scenario:

Significant quantities of client's securities were misappropriated by an employee of a licensed firm. Besides, unauthorized changes to client statements and computer records were noted.



Possible scope of review

1. **Circularization** of clients' accounts
2. **Investigation** of the alleged misappropriation of client assets and other fraudulent activities



Possible scope of review (Cont.)

3. **Review internal control systems and procedures, e.g.**
 - i. High level controls and management supervision
 - ii. Compliance function
 - iii. Account opening procedures and controls over client information
 - iv. Controls over discretionary accounts and third party operated accounts
 - v. Client orders handling and staff dealing
 - vi. Preparation and delivery of trading documents
 - vii. Client money and client securities
 - viii. Complaint handling
 - ix. IT controls



Reports and Follow-up Review

4. Reporting of work performed and findings

Usually expect submission of :

- i. Interim report
- ii. Final report

5. Follow-up review and report



Tips for conducting a successful review

▪ Engagement letter

- State clearly the objectives and scope of review, work to be performed and reporting timetable
- Confirm with all relevant counterparties before finalizing the terms of engagement letter
- Ensure all proposed changes to the terms of engagement are clearly communicated and agreed by the licensed firm and the SFC



Tips for conducting a successful review (cont.)

■ Review process

- Ensure the review is performed according to the agreed scope of review and completed within the agreed timetable
- Understand thoroughly the requirements of relevant rules and regulations
- Assign sufficient, experienced and competent staff to perform the review
- Carry out independent investigation and verification where appropriate
- Draw appropriate conclusion on each test / review area



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Tips for conducting a successful review (cont.)

■ Reporting process

- Submit the reports according to agreed time schedule
- Ensure the report fully covers all the agreed review areas
- Ensure the accuracy of the contents of report
- Report all deficiencies identified during the review
- Always draw conclusions on each review area and state clearly the conclusions and basis of the conclusions
- Provide practical recommendations to address control deficiencies or non-compliance identified



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Tips for conducting a successful review (cont.)

▪ Follow-up Review

- Evaluate whether the licensed firm has rectified all control deficiencies and non-compliance
- Conduct the follow up review and deliver the report according to pre-agreed timetable
- Report promptly if any major deficiencies have not yet been addressed or new issues are identified



Agenda

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Annual assessment on sponsor firms

Regulatory requirements

- **Paragraph 1.5.3 of Sponsor Guidelines**
 - A sponsor should carry out an assessment annually in order to ensure that its systems and controls remain effective. Any material non-compliance issue should be reported to the Commission promptly
- **Internal and / or external audit**
- **Scope of assessment**
 - Business structure
 - Specific risks related to business
 - Firm's own internal system
 - Track record of compliance



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Internal system and controls

Paragraph 1.5.1 of Sponsor Guidelines

- **Effective systems and controls to ensure:**
 - Adequate supervision and management of its employees who perform the services of a sponsor
 - Employees do not act beyond their proper authority
 - Compliance with all laws, regulations, codes and guidelines, including the Listing Rules



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Major Rules and Regulations

- **Sponsor Guidelines**
- **Code of Conduct for Corporate Finance Advisers**
- **Listing Rules, for example:**
 - Main Board: Chapter 3A and Practice Note 21
 - GEM Board: Chapter 6A and Practice Note 2
- **Others, for example:**
 - Code of Conduct
 - Internal Control Guidelines
 - Financial Resources Rules ...etc.



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Common System and Controls

- **Management supervision**
 - Sufficient resources are allocated
 - Each transaction is properly supervised by at least one Sponsor Principal
 - Effective reporting line and communication at operational level



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Common System and Controls (cont)

■ Management supervision (cont)

- Kept abreast of any key issues and risk areas relating to each sponsor engagement

■ Tips for successful review

- Review the transaction register
- Understand the role of staff members
- Evidences on the involvement of Sponsor Principals
- Staff training



Common System and Controls (cont)

■ Key operational procedures

- Deal acceptance / know your clients
- Due diligence process
- Systems in managing conflict of interest

■ Tips for successful review

- Proper approval process
- Documentation on due diligence planning and conclusion
- Audit trail on due diligence work
- Identification and reporting of material issues
- Proper Chinese Wall and Conflict Clearing



Common System and Controls (cont)

- **Record keeping**
 - Firm specific
 - Appointment and cessation of Sponsor Principal
 - List of sponsor transactions
 - Transaction specific
 - Appointment of transaction team
 - Due diligence work
- **Tips for successful review**
 - Transaction register
 - Due diligence file



Thank you

