



To: **HKSA members**
All other interested parties

EXPOSURE DRAFT

Practice Note

820

“The audit of licensed corporations and associated entities of intermediaries”

Comments to be received by 15 September 2003

*Issued by the Council,
Hong Kong Society of Accountants*

The Hong Kong Society of Accountants' Council (Council) has issued an exposure draft of proposed Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” for consultation.

A copy of the exposure draft is attached. The exposure draft can also be found on-line at: <
<http://www.hksa.org.hk/professionalttechnical/assurance/exposedraft/ed-pn820.pdf>>.

The Council welcomes comments on all aspects of the exposure draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, and if they clearly explain the concern or issue and provide a suggestion for alternative wording, if considered necessary, with supporting reasoning.

Comments are requested to be received by **15 September 2003** and may be sent by mail, fax or e-mail to:

Deputy Director (Ethics & Assurance)
Hong Kong Society of Accountants
4th Floor, Tower Two, Lippo Centre
89 Queensway
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Fax number: 2865 6776
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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

(June 2003)

PREFACE

1. Introduction

- 1.1 The purpose of the Exposure Draft (ED) is to provide guidance to auditors of licensed corporations and associated entities of intermediaries (collectively referred to below as “regulated entities”) in respect of:
- special considerations arising from the application of Statements of Auditing Standards to the audit of financial statements of regulated entities;
 - auditors’ reporting responsibilities under the Securities and Futures (Accounts and Audit) Rules, a subsidiary legislation under the Securities and Futures Ordinance (SFO); and
 - communications between auditors and the Securities and Futures Commission (SFC).

2. Background

- 2.1 In 1999 the Government announced legislative reform for the securities and futures market. This reform has resulted in the enactment of the SFO which came into effect on 1 April 2003, replacing the ten existing Ordinances which regulated the securities and futures market.
- 2.2 In order to ensure that the HKSA provides up-to-date guidance to practising members on the audits of regulated entities, the Expert Panel on Securities (EPS) is tasked with the responsibilities to develop a new PN to assist auditors in discharging their reporting responsibilities under the SFO.
- 2.3 Because of the scale of the project, the EPS spent a significant amount of its time and efforts over the past twelve months in developing the ED.

3. Consultation with the SFC

- 3.1 In developing the ED, the HKSA has worked closely with the SFC and the preliminary comments made by the SFC have been incorporated into the ED where appropriate.

4. Key changes to the current practice introduced by the new regulatory framework

4.1 Auditors’ reports

Under the current practice, auditors’ reports of regulated entities are composite reports covering both the financial statements and regulatory reporting.

During the consultation stage of the proposed Securities and Futures (Accounts and Audit) Rules, the HKSA has made a submission to the SFC stating that as a result of the issuance of the Standards on Assurance Engagements by the HKSA, it would be more appropriate for the auditors to prepare two separate auditors’ reports to satisfy the reporting requirements under the Rules, i.e. one report covering the financial statements and another report covering regulatory reporting. The SFC was receptive to the HKSA’s recommendation and the final Securities and Futures (Accounts and Audit) Rules reflect the HKSA’s recommendation.

ED/PN 820 (June 2003)

The ED has been prepared in line with the requirements of the new Securities and Futures (Accounts and Audit) Rules under which auditors prepare two separate auditors' reports covering the financial statements and regulatory reporting respectively. To achieve a greater degree of uniformity in audit reporting, example auditors' reports, including one for reporting periods which straddle 1 April 2003 (i.e. the effective date of the SFO), are provided in Appendix 1 to the ED.

4.2 Reporting on systems of control

Under the current practice, the SFC requests auditors to provide certain information that is not readily available from the audited financial statements in an Audit Questionnaire to assist it to carry out its functions of supervising regulated entities. This primarily covers various aspects of the systems of control of regulated entities.

Under the new Securities and Futures (Accounts and Audit) Rules, auditors are required to report on whether regulated entities have systems of control in place that are adequate to ensure compliance with certain sections of the client asset rules. The ED provides guidance on the control objectives and audit evidence in relation to the auditors' reporting on systems of control maintained by regulated entities with regard to client assets.

5. HKSA professional pronouncements to be withdrawn

5.1 On the finalization of the proposed PN, the following HKSA professional pronouncements will be withdrawn:

- PN 620.1 "Communications between auditors and securities and futures regulators";
- Industry Auditing Guideline 3.403 "The audit of the accounts of commodities dealers";
- Industry Auditing Guideline 3.404 "The audit of the accounts of dealers in securities"; and
- example auditors' reports 14 to 17 in Appendix 2 to SAS 600 "Auditors' reports on financial statements".

(June 2003)

**EXPOSURE DRAFT ISSUED FOR CONSULTATION
UNTIL 15 SEPTEMBER 2003**

PRACTICE NOTE

820

**THE AUDIT OF LICENSED CORPORATIONS AND
ASSOCIATED ENTITIES OF INTERMEDIARIES**

(Issued [])

The purpose of Practice Notes issued by the Hong Kong Society of Accountants is to assist auditors in applying Statements of Auditing Standards (SASs) and Standards on Assurance Engagements (SAEs) of general application to particular circumstances and industries.

They are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in SASs and SAEs, even though they may be developed without the full process of consultation and exposure used for SASs and SAEs. Auditors 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 auditors to develop an approach to the audit of the financial statements of licensed corporations and associated entities of intermediaries (dealt with in Part II).
2. This Practice Note also provides guidance on the auditors' other reporting responsibilities under the Securities and Futures Ordinance (SFO) which are set out in the Securities and Futures (Accounts and Audit) Rules (dealt with in Part III).
3. Guidance on the completion of the Securities and Futures Commission's (SFC) Audit Questionnaire by the auditors is set out in Part IV.
4. Auditors are entitled under the SFO to report directly to the SFC in exceptional circumstances and, in some cases, have a duty to do so. Guidance on such ad hoc reporting is set out in Part V.
5. This Practice Note has been prepared in consultation with the SFC.
6. This Practice Note is based on the SFO in effect as at 1 April 2003, and the subsidiary legislation, codes and guidelines issued by the SFC up to 30 April 2003. 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, auditors will wish to seek legal advice.

(June 2003)

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 asset rules*

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

c. *Codes and guidelines*

Codes and guidelines issued by the SFC under the SFO.

d. *FRR*

Securities and Futures (Financial Resources) Rules.

e. *HKMA*

Hong Kong Monetary Authority.

f. *Intermediary*

A licensed corporation or a registered institution.

g. *Internal Control Guidelines*

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

h. *Licensed corporation*

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

i. *Liquid assets*

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

j. *Liquid capital*

The amount by which liquid assets exceeds ranking liabilities.

k. *Ranking liabilities*

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

l. *Registered institution*

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

m. *Regulated activities*

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

n. *Regulated entity*

A licensed corporation or an associated entity of an intermediary.

o. *SFC*

Securities and Futures Commission.

- p. *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.
- q. *SFO*
Securities and Futures Ordinance.
- r. *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.
- s. *Systems of control*
The internal controls over trading, accounting, settlement and stock holding systems 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 regime of the SFO, any business entity which carries on or holds itself as carrying on a business in a regulated activity in Hong Kong is required to be licensed with or registered by 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. All 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 annual audited 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 authorized to conduct such business.
- 13. The regulatory powers of the SFO are vested in the SFC.
- 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 the 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, dishonorable and improper practices in the industry.

Regulated activities

15. The SFO covers nine regulated activities:

- a. dealing in securities;
- b. dealing in futures contracts;
- c. leveraged foreign exchange trading;
- d. advising on securities;
- e. advising on futures contracts;
- f. advising on corporate finance;
- g. providing automated trading services;
- h. securities margin financing; and
- i. asset management.

Auditors' statutory rights and duties

16. Guidance on the auditors' statutory rights and duties under the SFO is given in Parts II 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 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.

Licensing and registration

18. Persons carrying on business in a regulated activity in Hong Kong are required to apply 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. Auditors have no requirement to express an opinion on the business conduct of a regulated entity but need to be aware of the requirements.

21. The basic nine 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 registered institution, its associated entity or associated entity of a licensed corporation that is an authorized financial institution).
- 23. The Securities and Futures (Client Securities) Rules require client securities and securities collateral received or held in Hong Kong to be treated by regulated entities in a prescribed manner, such as depositing the securities in the safe custody of a segregated account. There are no prescribed rules for client securities received or held overseas.
- 24. The Securities and Futures (Client Money) Rules require segregation of client money received or held in Hong Kong by licensed corporations and their associated entities (unless they are authorized financial institutions) within the specified time limit. There are no prescribed rules for client money received or held overseas.

Record keeping

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

Financial resources requirements

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

PART II - THE AUDIT OF FINANCIAL STATEMENTS

28. Statements of Auditing Standards (SASs) 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 SASs to the audit of financial statements of regulated entities, and suggests ways in which these can be addressed. Where no special considerations arise in relation to a particular SAS, no material is included. For the specific requirements of a SAS, auditors should refer to the SAS concerned.

SAS 110: THE AUDITORS' RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS

Background note

When planning and performing audit procedures and evaluating and reporting the results thereof, the auditors should consider the risk of material misstatements in the financial statements resulting from fraud or errors. (SAS 110.1)

29. In addition to the conditions or events specified in SAS 110 as increasing the risk of fraud or error, 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. volatility in the market place; and
 - g. no established compliance culture or inadequate internal controls.
30. 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. Auditors need to bear in mind their responsibilities to report to the SFC in accordance with guidance set out in Part V below.

SAS 120: CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

Background note

When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditors should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. (SAS 120.1)

31. The auditors need 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 or 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.
32. Auditors of the 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 on its website for any known enforcement action of a particular regulated entity;
 - 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.

Money Laundering

33. Laws and regulations relating to money laundering are integral to the legal and regulatory framework within which regulated entities operate. By the nature of their business, regulated entities may be ready targets of those engaged in money laundering activities.
34. The primary bodies of law in Hong Kong concerned with the subject of money laundering are the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance. Details on the matters are set out in the related guidance note and circulars issued by the SFC.
35. The SFC expects the 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

36. Auditors have 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 entities; and
 - b. cause the regulated entities to have their business restricted or, in extreme cases, withdrawn, so threatening their viability as a going concern.
37. Auditors will also be aware that breaches of the codes and guidelines could have consequences for other matters which are the subject of the auditors' reporting responsibilities to the SFC - for example, financial resources, accounting records and the handling of client assets.
38. Auditors 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.

39. 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, auditors would gain an understanding of the regulated entity's operations, including the nature of the business carried out. They would also obtain an understanding of the control environment that exists, including the regulated entity's higher level procedures for complying with the applicable codes and guidelines.
40. 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.
41. Auditors need to be alert to any indication that a regulated entity is conducting business outside the scope of its authorization as this may amount to an offence under the SFO.
42. Where an apparent non-compliance of the codes and guidelines comes to the auditors' attention, they would ensure that the implications for their reporting responsibilities are correctly identified.
43. Auditors 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.

SAS 130: GOING CONCERN

Background note

When planning and performing audit procedures and in evaluating the results thereof, the auditors should consider the appropriateness of management's use of the going concern assumption underlying the preparation of the financial statements. (SAS 130.1)

44. In reviewing going concern, the auditors of a regulated entity would consider the following areas in addition to those set out in Appendix 1 of SAS 130, 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. non-routine 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.
45. If the auditors have any doubts as to the ability of a regulated entity to continue as a going concern, they may be required to make a report to the SFC under their statutory duties on which guidance is set out in Part V below.

SAS 140: ENGAGEMENT LETTERS

Background note

The auditors and the client should agree on the terms of the engagement, which should be recorded in an audit engagement letter or other suitable form of written contract. (SAS 140.1)

46. In addition to those principal contents set out in SAS 140, the auditors' engagement letter would also cover reporting requirements under the Securities and Futures (Accounts and Audit) Rules and in particular, the auditors' 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 auditors to report matters if found and does not involve undertaking additional work to identify them. It also clarifies that auditors may sometimes consider it necessary to report directly to the SFC without the client's prior knowledge or consent.

SAS 150: SUBSEQUENT EVENTS

Background note

The auditors should consider the effect of subsequent events on the financial statements and on the auditors' report. (SAS 150.1)

47. In addition to the specific procedures to identify subsequent events which may require amendment to, or disclosure in the financial statements outlined in paragraphs 9 and 10 of SAS 150, for the regulated entity, the auditors would review correspondence with the SFC since the period end and make enquiries of management to determine whether any breaches of the law, codes and guidelines or other regulatory concerns have come to light since the period end.

SAS 160: OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

Background note

Auditors should read the other information. If as a result the auditors identify any material inconsistencies between the financial statements and the other information, or become aware of any material misstatements of fact in the other information, they should seek to resolve them. (SAS 160.1)

48. The SFC has issued an Account Disclosure Document for Licensed Corporation setting out additional financial information to be disclosed in the financial statements of licensed corporations. Auditors would comply with the requirements in SAS 160 in respect of the additional financial information. Auditors are requested by the SFC to report any material inconsistencies between the additional financial information and the audited financial statements in the Audit Questionnaire. Details are set out in Part IV below.

SAS 200: PLANNING

SAS 210: KNOWLEDGE OF THE BUSINESS

Background note

Auditors should plan the audit work that the audit will be performed in an effective manner. (SAS 200.1)

In performing an audit of financial statements, auditors should have or obtain a knowledge of the business sufficient to enable them to identify and understand the events, transactions and practices that, in the auditors' judgement, may have a significant effect on the financial

statements or on the audit or the auditors' report. (SAS 210.1)

49. Regulated entities can be complex and auditors would seek to understand the business and the regulatory regime in which they operate. A fundamental principle embodied in the HKSA Professional Ethics Statements is that auditors do not accept or perform work which they are not competent to undertake. The auditors 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 knowledge of the business and an understanding of the high level control environment.
50. 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. Auditors plan so as to ensure that their 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 auditors' responsibilities are different from those for other types of entity.

Direct communication from the SFC

51. As explained in paragraph 163 below, the SFC is able to disclose information directly to auditors. Where such a matter has been brought to the attention of auditors, they consider its implications for their work and may amend their approach accordingly. However, the fact that they may have been informed of such a matter by the SFC does not, of itself, require auditors to change the scope of their work, nor does it require them actively to search for evidence in relation to the matter communicated by the SFC.
52. The auditors have no obligation to seek out breaches of the law, codes and guidelines. However, auditors 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.

SAS 300: AUDIT RISK ASSESSMENTS AND ACCOUNTING AND INTERNAL CONTROL SYSTEMS

Background note

The auditors should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditors should use their professional judgement to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level. (SAS 300.1)

53. 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. Auditors assess the adequacy of controls in relation to the circumstances of each entity. In addition to the factors set out in paragraph 12 of SAS 300, the following factors would be considered by the auditors in assessing whether there may be an increased level of inherent risk of material misstatement:
 - a. the nature and status of the regulated entities and any changes in their status which may affect the application of protection of clients' assets requirements;
 - b. a change in the market environment (for example, high volatility);
 - c. the introduction of new clients or products or marketing and distribution methods (for example e-commerce);
 - d. claims made in promotional literature (for example in relation to risks and performance);
 - e. the risk profile of business undertaken;

- f. the complexity of products;
 - g. the consistency of products, methods and operations in different departments or locations;
 - h. the legal and operational structure of the regulated entities;
 - i. where a group structure exists, the financial and managerial support provided to and by other group companies;
 - j. the number of branches or sales offices (see paragraph 56 below);
 - k. the use of licensed representatives;
 - l. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
 - m. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;
 - n. the recruitment, competence, training and supervision of personnel; and
 - o. the integrity, competence and experience of management.
54. Regulated entities vary greatly in the complexity of their operations and hence in the reliance which auditors place on their detailed internal controls. These are particularly important in cases where the accounting system is at risk of failing to capture transactions which do not involve the immediate movement of funds - such as trading in certain derivative instruments or underwriting. A sound understanding of the process is required in order to guard against the risk of unrecorded or mis-recorded transactions. These may or may not be unauthorized but will also expose the regulated entity to possible loss, through failure to appreciate the risks which are actually being run.
55. Client assets is one area where detailed internal controls are particularly relevant. While such assets are in principle not part of the audited financial statements, any material deficiency in the adequacy of internal controls over client assets will need to be reported in the Compliance Report (see paragraph 106 below). Auditors can refer to the Suggested Control Techniques.
56. Some regulated entities operate a network of branches. In such instances, the auditors determine 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. The extent and impact of visits from the SFC is also relevant. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the regulated entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to audit planning.

SAS 310: AUDITING IN A COMPUTER INFORMATION SYSTEMS ENVIRONMENT

Background note

The auditors should consider how a computer information systems (CIS) environment affects the audit. (SAS 310.1)

57. 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 auditors to require a detailed knowledge of the regulated entity's CIS.

58. As new CIS technologies emerge, they are frequently employed by the 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.

SAS 402: EXTERNAL CONFIRMATIONS

Background note

The auditors should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditors should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. (SAS 402.1)

59. 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.
60. For efficiency purpose, the auditors 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 circularization are set out in paragraph 60 of Appendix 2 to this PN.

SAS 420: AUDIT OF ACCOUNTING ESTIMATES

Background note

Auditors should obtain sufficient appropriate audit evidence regarding accounting estimates. (SAS 420.1)

61. Accounting estimates are used for valuation purposes in some, for example, over-the-counter derivatives and illiquid trading positions.
62. For various derivative instruments auditors may not be able to readily substantiate an independent fair market valuation. In these instances the regulated entities may arrange for some form of mathematical modelling to be undertaken to provide a valuation for review and testing by the auditors. The auditors would review the process for developing and testing the model which has been used by the regulated entities, and in particular the performance of the model in various conditions when compared with prices actually obtained in the market. This involves obtaining an understanding of the assumptions and a review of the estimates involved for reasonableness, consistency and conformity with generally accepted practices. Given the special complexities involved with these types of products it is common practice for a specialist in this area to be involved in the work.
63. If the use of such a specialist is planned, the auditors would obtain sufficient appropriate audit evidence that such work is adequate for the purpose of the audit in accordance with SAS 520 "Using the work of an expert".

SAS 440: REPRESENTATIONS BY MANAGEMENT

Background note

The auditors should obtain evidence that the directors acknowledge their collective

responsibility for preparation of the financial statements which give a true and fair view and are in accordance with the relevant financial reporting framework, and have approved the financial statements. (SAS 440.1)

64. In addition to the examples of representations given in SAS 440, the auditors 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 auditors all correspondence and notes of meetings with the SFC relevant to the auditors' examination;
 - c. that all complaints have been drawn to the attention of the auditors;
 - 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.

SAS 480: AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS

Background note

The auditors should consider how a service organization affects the client's accounting and internal control systems so as to plan the audit and develop an effective audit approach. (SAS 480.1)

65. Some regulated entities commonly 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.
66. 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;
 - b. responsibility for keeping records; and
 - c. responsibility for acts or omissions by the third party.

SAS 500: CONSIDERING THE WORK OF INTERNAL AUDITING

Background note

The external auditors should consider the activities of internal auditing and their effect, if

any, on external audit procedures. (SAS 500.1)

67. The Internal Control Guidelines requires an intermediary (where practicable) to establish an internal audit function. Therefore in the majority of cases, auditors would be considering the activities of this function.

SAS 520: USING THE WORK OF AN EXPERT

Background note

When using the work performed by an expert, the auditors should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit. (SAS 520.1)

68. For regulated entities carrying out complex transactions, it may be necessary to rely on experts to carry out valuation models. In such cases, the auditors will need to determine the need to use the work of an expert in accordance with SAS 520.

SAS 610: COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE INTEREST

Background note

The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. (SAS 610.1)

69. The SFC may request copies of auditors' management letters from regulated entities. Against this background, auditors may consider it prudent to include in their report to directors or management, as a matter of course, a statement that:
- a. the management letter has been prepared for the sole use of the regulated entities;
 - b. it must not be disclosed to a third party, or quoted or referred to, without the written consent of the auditors; and
 - c. no responsibility is assumed by the auditors to any other person.

Breach of laws and rules issued by the SFC

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

PART III - AUDITORS' REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

Introduction

72. This Part of the Practice Note is intended to provide a common approach to reporting by auditors on regulated entities and to establish clear unequivocal wording of auditors' reports such that a standard form of wording may be used by auditors when reporting. One benefit of establishing a standard form of report is that it removes any ambiguity as to the assurance obtained from auditors about compliance with the requirements of the SFO.
73. The work that auditors perform in respect of their reporting under the Securities and Futures (Accounts and Audit) Rules does not represent a second audit carried out in accordance with SASs but represents a set of additional procedures which, in conjunction with the evidence drawn from the audit work carried out in relation to the financial statements, will enable them to report as required. Example auditors' reports are set out in Appendix 1.

The auditors' reporting responsibilities

74. The auditors' 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.
75. The auditors' 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 relevant responsibilities of management are, broadly:
- a. to prepare annual financial statements in accordance with generally accepted accounting principles;
 - b. to prepare applicable returns as detailed in section 56 of the FRR;
 - c. to ensure that the client asset rules and the Securities and Futures (Keeping of Records) Rules are observed; and
 - d. to prepare the business and risk management questionnaire.

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

76. The precise matters on which auditors are required to report vary according to the nature of the regulated entity's activities. In general the auditors' report is required to cover the following matters:
- a. whether the financial statements give a true and fair view;
 - 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;
 - c. whether the required returns as detailed in section 56 of the FRR have been correctly compiled from the records of the licensed corporation or, if not correctly compiled, the nature and extent of the incorrectness;
 - d. 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;

- e. whether the regulated entity complied with the Securities and Futures (Keeping of Records) Rules and the client assets rules during the financial year in question; and
- f. whether there appears to have been any contravention of the FRR by the licensed corporation during the financial year in question.

Details are set out in section 4 of the Securities and Futures (Accounts and Audit) Rules.

77. The objective of accounting systems and controls is to provide a reasonable level of assurance that assets are safeguarded against loss from unauthorized use or disposition, that risks are properly monitored and evaluated and that transactions are executed in accordance with established procedures and are recorded properly. Accounting systems and controls also assist management in conducting the business in a prudent manner. In considering the adequacy of systems of control required by the client asset rules and the Securities and Futures (Keeping of Records) Rules, auditors 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.
78. In discharging their reporting responsibilities regarding a regulated entity, auditors must have particular regard to any changes in the requirements of the SFC in force during the financial year to which the report relates.

Other considerations

Planning

79. The nature of the business undertaken by a regulated entity, its size and its particular circumstances will affect the nature and extent of the auditors' work. When planning their work, the auditors assess the risks associated with the nature of the particular regulated entity. Certain risks will not be applicable to all regulated entities.
80. Other factors that will be considered are:
- a. the scope of authorization in relation to the holding of client assets;
 - b. the extent of investment management discretion permitted;
 - c. the introduction of new requirements;
 - d. changes to existing requirements; and
 - e. modifications or waivers granted or special conditions imposed by the SFC.
81. In making an assessment of various risk factors, auditors would normally meet senior management and the Compliance Officer as part of their planning process. They would also consider the following:
- a. operational manuals;
 - b. documentation of systems and controls;
 - c. compliance monitoring programmes and results;
 - d. the records maintained by the regulated entity of any non-compliances and notifications to the SFC that may have occurred during the period under review;
 - e. correspondence with the SFC, relating to financial returns and any other matters;
 - f. the results of inspection visits made by the SFC;
 - g. the register of complaints received from clients during the period under review; and
 - h. any relevant internal audit reports.

Audit evidence

82. As with the audit of the financial statements, the auditors plan and perform their work so that they obtain sufficient evidence for their opinion. When doing so, they consider what is material, recognizing the nature and scale of the regulated entity concerned. It is not feasible, nor necessary, for the auditors to examine every transaction reflected in the records, nor to achieve complete satisfaction that the systems of control operate totally effectively.

The auditors' reports

83. Two separate auditors' reports are prepared in respect of the period under review. One contains an audit opinion on the financial statements of the regulated entity pursuant to the Companies Ordinance requirements, and 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 of this auditors' report is given in Example 1 of Appendix 1. For financial statements which straddle 1 April 2003 (the effective date of the SFO), an example auditors' report for a regulated entity which was previously a securities dealer regulated under the old Securities Ordinance is given in Example 1A of Appendix 1 to this PN.
84. The auditors' report on the financial statements will be expressed in true and fair terms.
85. The other (the Compliance Report) contains the auditors' conclusions on matters set out in paragraph 76(c) to 76(f) above. An example of the Compliance Report for a licensed corporation is given in Example 2 of Appendix 1 to this PN. The example report provides standard wording for the opinion required for all categories of regulated activities. An example of the Compliance Report for an associated entity of an intermediary is given in Example 3 of Appendix 1 to this PN. Guidance on the detailed requirements of the Compliance Report is set out below.
86. Both auditors' reports are required to be submitted by the regulated entities to the SFC within four months of their year end. Auditors would take all reasonable steps for their reports to be issued in order for the regulated entities to submit them to the SFC by the specified date.

The addressee

87. The Compliance Report will be addressed to the directors of the regulated entity.

The assurance standards followed

88. Auditors would state that they have conducted their Compliance Reporting engagement in accordance with Standards on Assurance Engagements issued by the HKSA, and with reference to this Practice Note. They also state that they have carried out such procedures as were considered necessary for their report.

Reporting requirements

Financial resources

89. Licensed corporations are required to prepare financial returns under the FRR. The eight returns required to be submitted to the SFC are:
- a. liquid capital computation;
 - b. required liquid capital computation;
 - c. summary of bank loans, advances and other credit facilities;
 - d. analysis of margin clients;
 - e. analysis of collateral received from margin clients;
 - f. analysis of rolling balance cash clients;

- g. analysis of client assets; and
 - h. analysis of proprietary derivative positions.
90. Auditors are required to give an opinion as to whether the financial returns submitted by the licensed corporation 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 auditors 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. The auditors' judgement as to the appropriate measure of materiality will be based on an understanding of the level of error which might mislead the SFC. 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 rules and results in a higher possibility of window dressing.
91. Auditors are requested by the SFC to provide a reconciliation in connection with the year-end liquid capital calculation if they have identified material discrepancies or reclassifications from the balances reported in the year-end financial return submitted by the licensed corporation to the SFC. This reconciliation will be attached to the Compliance Report.
92. In particular the auditors 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 return.

Accounting records and systems

93. Auditors are required to report whether the regulated entity has satisfied the requirement of the Securities and Futures (Keeping of Records) Rules during the period under review. In order to report on whether the regulated entity has satisfied the requirement 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.
94. The Securities and Futures (Keeping of Records) Rules set out the basic characteristics of adequate accounting records in general and include some guidance on the contents of specialized accounting records, especially those concerned with client assets. Management, in establishing and maintaining accounting records, and the auditors, 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.
95. The Securities and Futures (Keeping of Records) Rules require that intermediaries shall in relation to the businesses which constitute any regulated activities for which they are licensed or registered and their associated entities as regards the receipt or holding of client assets in relation to such regulated activities, to keep, where applicable, such accounting, trading and other records as are sufficient to:

a licensed corporation

- a. explain, and reflect the financial position and operation of, such businesses;
- b. enable profit and loss accounts and balance sheets 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 to establish whether it has complied with the FRR; and

- h. include records specified in the Schedule to and section 5, 6, 7(2) or 8 of the Securities and Futures (Keeping of Records) Rules.

an associated entity

- a. account for all client assets (however the Securities and Futures (Client Money) Rules do not apply to associated entities that are authorized financial institutions or associated entities of registered institutions);
- b. enable all movements of such 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.

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 intermediaries involved in certain regulated activities.

- 96. Detailed guidance on the control objectives and audit evidence in relation to the auditors' reporting requirements with regard to client assets under the Securities and Futures (Accounts and Audit) Rules are included in Appendix 2. Auditors will need to apply their judgement in determining the extent and nature of their work which would be based on a good understanding of the regulated entity's systems of control.
- 97. 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.
- 98. Within this control environment, the control procedures needed to ensure that the business is conducted to protect investors' interests would be commensurate with the regulated entity's needs and particular circumstances, and also with the inherent risks of the business undertaken. The size of the regulated entity will have an important bearing on the design and formality of the systems and controls. The operating procedures and methods of recording and processing transactions used by small regulated entities often differ significantly from those of large regulated entities. Internal controls which would be relevant to a large regulated entity, may not be practical or appropriate in a small one. Management of a small regulated entity has less need to depend on formal controls for the reliability of the records and other information, because of personal contact with, or involvement in, the operation of the business itself. Nevertheless the need for a positive attitude to the control environment is equally relevant in both small and large regulated entities.
- 99. Management would consider these factors in the design and maintenance of their systems of control. It would also recognize where appropriate the cost of a particular control, as against its purpose and expected benefit.

100. For the foregoing reasons, different systems and controls may be deemed adequate in different regulated entities, if they provide reasonable assurance that certain control objectives have been achieved. In designing the systems and controls, management would address inter alia the following general control objectives:
- a. the business is planned and conducted in an orderly, prudent and cost-effective manner in adherence to established and documented policies;
 - b. transactions and commitments are entered into only in accordance with management's general or specific authority;
 - c. client assets are safeguarded and are completely and accurately recorded;
 - d. the assets are safeguarded and the liabilities controlled;
 - e. the risk of loss from fraud, other irregularities and error is minimized, and any such losses are promptly and readily identified;
 - f. management is able to monitor on a regular and timely basis the regulated entity's business's position relative to its risk exposure;
 - g. management is able to prepare complete and accurate returns for the SFC on a timely basis in accordance with the FRR; and
 - h. issues relating to compliance with the law, codes and guidelines are resolved in a timely manner to the satisfaction of the SFC.
101. 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.
102. 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.
103. 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.
104. 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 auditors would consider whether appropriate documentation is a prerequisite of an adequate system.
105. 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 auditors 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.
- Client assets*
106. There are essentially two aspects to the auditors' reporting responsibilities for client assets:
- a. whether during the period under review, the regulated entity had systems of control in place that were adequate to enable compliance with the relevant sections of the client asset rules; and
 - b. whether during the period under review, the regulated entity complied with the relevant sections of the client asset rules.

107. Guidance on the control objectives and audit evidence is set out in Appendix 2 to this PN. Auditors apply their judgement in determining the extent and nature of their work which is based on the following general requirements:
- a. the auditors understand the business of the regulated entity and the environment in which the regulated entity operates;
 - b. the auditors review 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 auditors test those systems and controls to establish that they are operating effectively.
108. When planning and carrying out their work, the auditors 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.
109. Certain licensed corporations do not receive or hold client money or client securities either by choice or by limitation of their licensing condition. However, the auditors would ensure that such licensed corporations have procedures to avoid receipt or holding of client assets.

The identity of the auditors

110. The Compliance Report indicates clearly the name and address of the auditors.

The date of the report

111. It is highly desirable that the Compliance Report is dated with the same date of the auditors' report on the financial statements.
112. If the Compliance Report is dated at a later date than the auditors' report on the financial statements, auditors will undertake procedures to obtain assurance that any material events occurring after the date of the first report are identified and appropriate action is taken.

Qualified reports

113. Auditors may qualify their 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 auditors must report have not been met, their report includes a statement specifying the relevant requirements and the respect in which they have not been met, in sufficient detail for the breach or shortcoming to be clearly understood and evaluated. In particular, where the breach relates to a specific rule, the rule number or reference will be stated in the report.
114. 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, auditors analyze the circumstances in order to identify its cause, and establish the action management has taken or intends to take to correct the matter.
115. If the auditors propose to include any qualification or adverse statement in the Compliance Report (or their report on the financial statements), they are required under section 157(1)(b) of the SFO, as soon as reasonably practicable after they first propose the inclusion of the qualification or adverse statement, to lodge with the SFC a report. Details are set out in Part V below.
116. The Securities and Futures (Accounts and Audit) Rules do not provide that trivial breaches can be disregarded. Where small exceptions are discovered (e.g. as a result of reconciliations and confirmations of securities held for clients), the auditors will need to qualify their opinion, although references can be made to the extent of the breach.

PART IV - OTHER REPORTING CONSIDERATIONS

Audit Questionnaire

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

Additional financial information

120. The SFC has issued the Account Disclosure Document for Licensed Corporation which sets out additional financial information to be disclosed in the financial statements of licensed corporations. In the Audit Questionnaire auditors are requested by the SFC to state whether they are 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 their attention. Auditors would perform procedures on the additional financial information in accordance with SAS 160 "Other information in documents containing audited financial statements". If the auditors are aware of any material inconsistencies, they state details of such inconsistencies in the Audit Questionnaire.

PART V - COMMUNICATIONS BETWEEN AUDITORS AND THE SECURITIES AND FUTURES COMMISSION

Introduction

121. This Part of the Practice Note is concerned with communications:
- a. by auditors to the SFC under the obligations established in section 157 of the SFO;
 - b. by auditors to the SFC under the protection of section 158 of the SFO; and
 - c. by the SFC to auditors under section 378(3)(h) of the SFO.

Because of the variety of conditions which might be encountered, the guidance in this Part of the PN 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 auditors would be well advised to consult with their lawyers when they encounter such circumstances.

122. Under the SFO auditors have various statutory responsibilities to report to the SFC. They are automatically protected in making a report in discharge of such a statutory responsibility. Certain provisions of the SFO also provide the auditors with immunity from any liability they might otherwise incur by reason of their making other reports to the SFC which they may consider to be relevant to the functions of the SFC. These responsibilities and avenues available for reporting do not require the auditors to change the scope of their audit work, nor the frequency or timing of their visits.
123. 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 auditors, to protect the investors from the normal risks relating to such investment activities.
124. Auditors need to bear in mind that their decision may have to stand up to examination at a future date on the basis of the following considerations:
- a. what they knew at the time;
 - b. what they should have known in the course of their audit;
 - c. what they should have concluded; and
 - d. what they should have done.

Auditors to lodge report with the SFC in certain cases

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

125. Auditors have a statutory duty to lodge report with the SFC in the following circumstances:
- a. if they decide to include in their 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 auditors first propose the inclusion of the qualification or adverse statement; and
 - b. if they resign before the expiration of their term of office, intend not to seek re-appointment or otherwise cease to be auditors (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 auditors consider should be brought to the attention of the SFC, or where there are no such circumstances state the fact.

Section 157(1)(a) of the SFO

126. Section 157(1)(a) of the SFO provides that auditors shall lodge a written report with the SFC, as soon as reasonably practicable after they become aware of any “reportable matter”. A reportable matter is defined in section 157(3) of the SFO as:
- a. any matter which in the auditors’ 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.

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

127. 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 auditors under section 157 of the SFO” in section 5 of the Securities and Futures (Accounts and Audit) Rules.

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

128. The auditors 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 126 above exist. A distinction must be drawn here between an auditors’ duty as stated in paragraph 126(a) and paragraph 126(b) above. The duty under paragraph 126(b) is clear and unequivocal: if the auditors become aware of a contravention of the requirements which are specified, they are not given any latitude for exercising judgement. They are obliged to make a report. The duty under paragraph 126(a) is different. They are 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.
129. The HKSA has developed a criterion for use by auditors in deciding to take the initiative in lodging a written report with the SFC under paragraph 126(a) above. The criterion is that auditors would lodge a written report with the SFC when they consider 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.
130. This criterion can be more fully explained as follows:
- a. there must be a significant adverse occurrence or a change in the auditors’ 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.
131. Examples of the circumstances encountered in which the situation set out in paragraphs 129 and 130 may be met include:
- a. the auditors discover 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

132. In circumstances where auditors conclude that a written report under section 157(1)(a) of the SFO to the SFC is necessary, they would adopt the following procedures, bearing in mind that speed may be of the essence and that their statutory obligation to report under section 157(1)(a) of the SFO remains subject to the criterion discussed in paragraphs 128 to 131 above:
- a. The auditors 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 auditors' 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 auditors would then immediately lodge a written report with the SFC. They would follow this with a written notification along with a copy of their report to the directors or management to inform them.
133. The auditors would note that lodging a written report with the SFC alone may not discharge all their responsibilities. For example, they would consider the implications of the matter giving rise to the report under section 157(1)(a) of the SFO for their opinion on the financial statements, and their conclusions in the Compliance Report.

Other communications by the auditors

Statutory protection under section 158 of the SFO

134. 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 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 ...".
- Section 158 of the SFO only gives immunity for auditors 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 to 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)).
135. Section 158 of the SFO does not lay down any rules nor specify the circumstances in which the auditors are to communicate any matter to the SFC. They provide a mechanism whereby the auditors may make matters known to the SFC with statutory protection from their duty of confidentiality.
136. 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 auditors are obliged to report (see paragraphs 125 to 133 above). In interpreting this guidance, the auditors 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. Auditors would have regard to any function of the SFC as summarized in section 5 of the SFO.

137. Confidentiality is an implied term of auditors' contract with their client, but in certain circumstances and under conditions specified in section 158 of the SFO it does not prevail, since auditors of a regulated entity are entitled to communicate in good faith to the SFC information or opinion on a matter which they become aware of in their capacity as auditors 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.
138. 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.
139. Matters which may be reported under the protection of section 158 of the SFO will only arise in circumstances other than where the auditors are 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 auditors' knowledge of these matters may have been obtained while assisting the SFC rather than in their capacity as auditors (see paragraph 143 below).
140. Examples of circumstances in which the auditors may communicate any matter to the SFC under section 158 of the SFO include:
- a. the auditors consider 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 auditors 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.
141. Clearly the potential nature of matters which may be reported is very wide, but as explained in paragraph 144 below this does not, of itself, require the auditors to extend the scope of their work in order to discover matters and it will only be in exceptional circumstances such as those described in paragraphs 155 and 156 that they may choose to seek statutory protection.
142. Any protected communication can be made either on the auditors' initiative or in response to a request from the SFC for information. The auditors would cooperate with the SFC and respond to any requests from the SFC for information, provided they have no reason to doubt that the request is relevant to the SFC's functions. The auditors may communicate a matter to the SFC with the protection of section 158 of the SFO regardless of the source of that information, provided they became aware of the matter in their capacity as auditors of the regulated entity and they do so in good faith.

143. Matters of which the auditors become aware “in their capacity as auditors” may not be restricted to those matters identified during the course of the audit work by the auditors and members of the audit team. The auditors 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 their 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 auditors, 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 auditors (see also paragraph 144 below).
144. The auditors cannot be expected to be aware of all circumstances which, had they known of them, would have led them to exercise their right to communicate under section 158 of the SFO. This section does not require the auditors to change the scope of their audit or other work for the regulated entity, nor the frequency or timing of their visits. The auditors have 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 auditors to conduct their work in such a way that there is reasonable certainty that they will discover a matter upon which the SFC may need to act. It is only when the auditors do 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 they would consider using the protection of section 158 of the SFO.
145. The auditors would, however, ensure that they are made aware of any other relationships which may exist between any department of their firm and the regulated entity which could affect their work as auditors. The SFC expects that auditors will ensure that they are informed of all potentially exceptional circumstances (see paragraphs 155 and 156 below) by all other departments within their firm which have a relationship with the regulated entity. It would therefore be prudent for the audit firm to ensure any exceptional circumstances which may give rise to reports under section 158 of the SFO are brought to the attention of the auditors of that client in order that they can, if appropriate, make enquiries in their capacity as auditors to ascertain whether such matters need to be reported to the SFC.
146. The SFC recognizes that it would not be appropriate for the auditors to report information which they have obtained or matters which they have identified through their professional relationship with another client, even though the information obtained or the matters identified may relate to a regulated entity. However, the SFC expects a regulated entity to advise its auditors 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 auditors with copies of reports by such a third party promptly after their receipt. The auditors can, if appropriate, make enquiries in their capacity as auditors to ascertain whether any findings of the reports need to be reported to the SFC.
147. The auditors would need to realize that section 158 of the SFO will not provide protection where they 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. Auditors 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 their report are such as to secure the protection of section 158 of the SFO and that it only includes relevant material.

148. Auditors are protected, however, even if the information which they communicate subsequently falls short of proof, or the opinion which they communicate cannot be verified. Auditors who can demonstrate that they have acted reasonably and in good faith in informing the SFC of any information or opinion on a matter which they think has occurred would not be held in breach of duty to their client even if, after an investigation, it were found there was not a matter which needed to be reported. These are areas where the auditors may wish to consider taking legal advice before making a report.
149. Whilst no breach of statutory duty might arise, it should be appreciated that there is no protection given by the SFO if the auditors, after becoming aware of an occurrence, fail to report, promptly, or at all, to the SFC. Furthermore, auditors 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

150. As part of the SFC's system of supervision of regulated entities, meetings involving the SFC, the regulated entity and its auditors may be called by either the SFC, or the regulated entity possibly at the auditors' suggestion.
151. Auditors 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 auditors' report or of a change in a previously reported intention to qualify an auditors' 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 auditors have drawn to its attention since any previous meeting, including how such matters have been resolved to the satisfaction of the auditors or have been reflected or treated in the financial statements.

Reporting via the regulated entity

152. Where the auditors become aware of a matter which, in their professional judgement, they consider is not required to be reported under section 157 of the SFO but ought to be reported to the SFC, they would consider the facts and, unless inappropriate in the circumstances (described in paragraph 155 below), discuss the matter with the management.
153. It is important for the auditors to act in a manner that will maintain their professional relationship with their client. Normally, therefore, the auditors would ask the regulated entity to draw matters about which they are concerned to the attention of the SFC.
154. Where the regulated entity will not itself inform the SFC of a matter, having been advised to do so by the auditors, 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 auditors would make such a report direct to the SFC.

Reporting direct to the SFC

155. In exceptional circumstances, where the auditors doubt 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 auditors 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 auditors no longer to have confidence in the integrity of the directors or senior management, eg. where they believe that a fraud or other irregularity has been committed by the directors or senior management of the regulated entity, or they have 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 auditors 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, eg. where they have 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 they have evidence of their inclination so to act.
156. The auditors would also report direct to the SFC when speed is of the essence. For example, when they become aware that the regulated entity may be about to cease being licensed, the auditors would consider the need to disclose to the SFC any information in their 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.

Auditors' duty of secrecy

157. Section 378 of the SFO imposes a duty of secrecy upon any "specified person", within the meaning of that term in section 378(15). Auditors are bound by the duty of secrecy once they perform any function under or carry into effect any of the provisions of the SFO or assist another person in the performance of any function under or in carrying into effect any such provisions.
158. The precise scope of an auditors' statutory duty of secrecy is not definitive but is likely to include:
- a. any matter which, in the auditors' 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 auditors 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 auditors to the SFC (SFO section 157(1)(a)) and the contents of that written report;
 - c. the auditors' decision to resign before the expiration of their term of office, the auditors' decision not to seek re-appointment, or if the auditors otherwise cease to be auditors, 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 auditors' 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 auditors 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 they become aware in their capacity as auditors, whether or not they are at the time of such communication still the auditors of the regulated entity concerned; and
 - f. any communication by the SFC to the auditors under section 378(3)(h) of the SFO (see paragraphs 163 – 165 below).
159. Application of section 378 of the SFO would therefore prevent the auditors from communicating any matters such as those referred to in paragraph 158 above to any parties other than the SFC except under certain circumstances as discussed in paragraphs 160 and 161 below in relation to the matters mentioned in paragraph 158(c) above. It should be emphasised that application of section 378 of the SFO would also prevent the auditors 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.
160. Section 140A(2) of the Companies Ordinance states that an auditors' notice of resignation shall not be effective unless it contains either (i) a statement to the effect that there are no circumstances connected with their resignation which they consider should be brought to the notice of the members or creditors of the company; or (ii) a statement of any such circumstances as aforesaid. Thus, the incoming auditors and members or creditors of a regulated entity may be informed by the outgoing auditors regarding their reasons to resign, not to seek re-appointment or otherwise cease to be the auditors. Disclosure of such information by the outgoing auditors 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.
161. In complying with a request by the incoming auditors to provide professional clearance which is required under HKSA Professional Ethics Statement 1.207 "Changes in a professional appointment", the outgoing auditors may communicate the matters referred to in paragraph 158(c) to the incoming auditors. The outgoing auditors are 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 auditors can accept nomination as auditors of the regulated entity under section 153 of the SFO.
162. Under this Practice Note, auditors would prepare two auditors' reports separately in respect of reporting on the financial statements (see paragraph 83 above) and compliance reporting (see paragraph 85 above). Since the Compliance Report by auditors 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 auditors can disclose any contraventions by the regulated entity of the requirements referred to in paragraph 158(b) in the Compliance Report without breaching the duty of secrecy under section 378 of the SFO.

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

163. Section 378(3)(h) of the SFO empowers the SFC to disclose confidential information to auditors 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 auditors is to them only; they are not free to pass that information to others, such as their client regulated entity without the consent of the SFC.
164. The SFC will generally take the initiative in bringing a matter to the attention of auditors of a regulated entity, under the provisions of section 378(3)(h) of the SFO, where it believes that it is of such importance that the auditors' knowledge of it could significantly affect the form of their audit report or the way in which they carry out their reporting responsibilities. The SFC has also indicated that it will inform the auditors whether the regulated entity's management has been informed of the matter and, if so, who has been advised.

165. If the auditors are not informed by the SFC of any such matter, they are entitled to assume that the SFC has no such information. Accordingly, there is no need for the auditors to request the SFC to confirm this.

APPENDIX 1 – EXAMPLES OF AUDITORS’ REPORTS

Example 1 – auditors’ report on the financial statements of a regulated entity – unqualified opinion

AUDITORS’ REPORT TO THE SHAREHOLDERS OF XYZ SECURITIES LIMITED (incorporated in Hong Kong with limited liability)

We have audited the financial statements on pages ... to ... which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company’s circumstances, consistently applied and adequately disclosed.

We have planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion:

- a. 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; and
- b. the financial statements give a true and fair view of the state of the company’s affairs as at [*year end date*] and of its profit [loss] and cash flows for the year then ended and have been properly prepared in accordance with the Companies Ordinance.

ABC & Co.
Certified Public Accountants
Hong Kong
Date

**Example 1A – auditors’ report on the financial statements
of a regulated entity which was previously a securities dealer regulated under
the old Securities Ordinance, which straddle 1 April 2003 – unqualified opinion**

**AUDITORS’ REPORT
TO THE SHAREHOLDERS OF XYZ SECURITIES LIMITED**
(incorporated in Hong Kong with limited liability)

We have audited the financial statements on pages ... to ... which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you. We are also required to report under the Securities (Accounts and Audit) Rules on matters relating to the requirements of sections 81 or 81A, 83 and 84 of the Securities Ordinance and the Financial Resources Rules for the period from [] to 31 March 2003.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants. Our audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and to the compliance by the company with the above sections of the Securities Ordinance during the period from [] to 31 March 2003. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company’s circumstances, consistently applied and adequately disclosed.

We have planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement and the company complied with the above sections of the Securities Ordinance during the period from [] to 31 March 2003. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

We report that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit.

In our opinion:

- a. the financial statements give a true and fair view of the state of the company’s affairs as at [*year end date*] and of its profit [loss] and cash flows for the year then ended and have been properly prepared in accordance with the Companies Ordinance;
- b. during the period from [] to 31 March 2003, the company has properly kept all securities to which section 83(3)(a)(vi) of the Securities Ordinance applies in accordance with section 81 or 81A, as the case may be, of the Securities Ordinance;

ED/PN 820 (June 2003)

- c. during the period from [] to 31 March 2003, the company has properly kept the records required to be kept by it under section 83 of the Securities Ordinance;
- d. the financial statements are in accordance with the records kept under section 83 of the Securities Ordinance and comply with the requirements of the Securities (Accounts and Audit) Rules for the period from [] to 31 March 2003, and 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 for the period from 1 April 2003 to *[year end date]*; and
- e. during the period from [] to 31 March 2003, the company has properly kept all trust accounts in accordance with section 84 of the Securities Ordinance.

We are not aware of any instances during the period from [] to 31 March 2003 where the company has contravened the Financial Resources Rules.

ABC & Co.
Certified Public Accountants
Hong Kong
Date

**Example 2 – report by auditors on a licensed corporation’s compliance
with certain requirements of the rules made under the
Securities and Futures Ordinance – unqualified conclusion**

**COMPLIANCE REPORT BY THE AUDITORS
TO THE BOARD OF DIRECTORS OF XYZ SECURITIES LIMITED**

We have audited the financial statements of the company for the year ended *[year end date]* in accordance with Statements of Auditing Standards and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants, and have issued [an unqualified/a qualified] auditors’ report thereon dated *[insert date here]*.

Pursuant to section 156 of the Securities and Futures Ordinance, we are also required to issue this Compliance Report for [the period from 1 April 2003 to/the year ended] *[year end date]* for submission by the company to the Securities and Futures Commission (SFC).

Respective responsibilities of directors and auditors

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

- a. each of the returns as referred to in section 56 of the Securities and Futures (Financial Resources) Rules is correctly compiled from the records of the company;
- b. 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 Securities and Futures (Client Money) Rules; and
 - ii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules;
- c. the company has complied with:
 - i. sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
 - ii. sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
 - iii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules; and
- d. the company has complied with the 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 Standards on Assurance Engagements and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants.

In relation to our conclusion 1(a) and conclusion 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.

In relation to our conclusion (2) below, we are not required to perform any procedures to search for instances of contravention of the 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 returns made up to *[year end date]* on pages [] to [] from the records of the company;
 - b. during *[the period from 1 April 2003 to/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 Securities and Futures (Client Money) Rules; and
 - ii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules;
 - c. during *[the period from 1 April 2003 to/the year ended] [year end date]*, the company complied with:
 - i. sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
 - ii. sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
 - iii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules; and
2. we are not aware of any instances during *[the period from 1 April 2003 to/the year ended] [year end date]* where the company has contravened the Securities and Futures (Financial Resources) Rules.

Use of this report

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

ABC & Co.
Certified Public Accountants
Hong Kong
Date

Example 3 – report by auditors on an associated entity of an intermediary’s compliance with certain requirements of the rules made under the Securities and Futures Ordinance – unqualified conclusion

**COMPLIANCE REPORT BY THE AUDITORS
TO THE BOARD OF DIRECTORS OF XYZ NOMINEE LIMITED**

We have audited the financial statements of the company for the year ended *[year end date]* in accordance with Statements of Auditing Standards and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants, and have issued *[an unqualified/a qualified]* auditors’ report thereon dated *[insert date here]*.

Pursuant to section 156 of the Securities and Futures Ordinance, we are also required to issue this Compliance Report for *[the period from 1 April 2003 to/the year ended]* *[year end date]* for submission by the company to the Securities and Futures Commission (SFC).

Respective responsibilities of directors and auditors

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. sections 4, 5, 6, 8(4), 10, 11 of the Securities and Futures (Client Money) Rules; and
 - ii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules; and
- b. the company has complied with:
 - i. sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
 - ii. sections 4, 5, 6, 8(4), 10 and 11 of Securities and Futures (Client Money) Rules; and
 - iii. sections 4(4), 5, 10(1) and 12 of the 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 Standards on Assurance Engagements and with reference to Practice Note 820 “The audit of licensed corporations and associated entities of intermediaries” issued by the Hong Kong Society of Accountants.

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

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

Inherent limitations

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

Conclusion

Based on the foregoing, in our opinion:

- a. during [the period from 1 April 2003 to/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 Securities and Futures (Client Money) Rules; and
 - ii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules; and
- b. during [the period from 1 April 2003 to/the year ended] *[year end date]*, the company complied with:
 - i. sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
 - ii. sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
 - iii. sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules.

Use of this report

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

ABC & Co.
Certified Public Accountants
Hong Kong
Date

APPENDIX 2 – CLIENT ASSETS

INTRODUCTION

1. This Appendix provides more detailed guidance to auditors on the work normally carried out in order to form an opinion on client assets in the auditors' 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. 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 auditors in determining the scope of the work for each individual audit. However it is not intended to limit or replace individual professional judgement, 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 judgement in the light of the circumstances of each particular case.
6. Where the auditors discover that the systems have failed or material differences have arisen, they consider the implications these may have on other areas of their work, on their reporting obligations and, in particular, on the "truth and fairness" of the financial statements.

CLIENT SECURITIES

Introduction

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

These securities may be held in the form of collateral.

8. The Client Securities Rules do not apply to client securities of an intermediary that are in an account established and maintained by a client of an intermediary, in that client's name, with a person other than the intermediary or an associated entity of the intermediary.
9. For the particular regulated activity, the auditors need to understand what may constitute client securities that are covered by the Client Securities Rules. They 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 auditors need 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 auditors' 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 auditors, to enable them to fulfill their reporting requirements, are:
 - a. whether during the period under review, the regulated entity had adequate systems of control in place to ensure compliance with the sections 4(4), 5, 10(1) and 12 of the Client Securities Rules;
 - b. whether during the period under review, the regulated entity has complied with the sections 4(4), 5, 10(1) and 12 of the Client Securities Rules; and
 - c. whether during the period under review, the regulated entity has complied with sections 3 and 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 collateral will need to meet and the evidence that may be available to the auditors upon which they can base their 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 auditors 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 auditors may place greater reliance on observation and enquiry for their audit evidence than inspection of documentation. In doing so, they need to bear in mind that undocumented systems are more prone to error and fraud, and that their 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 (or held physically as a separate certificate) different from that in which its house positions are deposited;
 - c. for bearer documents of title, that the owner can be identified at all times and that it is readily apparent which securities relate to the house positions and which to the client;
 - d. securities held as collateral can be separately identified;

- e. arrangements for releasing documents under stock lending and borrowing arrangements are in accordance with the rules;
- f. satisfactory arrangements for ensuring that the client securities were held or securities collateral kept after receipt in a segregated account and registered in the name of the client from whom or on whose behalf the client securities have been received, or the intermediary or associated entity;
- g. 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;
- h. 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;
- i. risk assessments to be carried out on all custodians to assess the risk of placing client securities and securities collateral with a third party;
- j. written arrangements between the intermediary or associated entity and the custodian covering at least the minimum requirements of the rules; and
- k. 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 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. physical segregation of bearer securities held for clients from those belonging to the regulated entity and, where practicable, segregation among individual clients;
 - f. separate registers maintained of securities held as collateral;
 - g. evidence of appropriate authority to engage in stock lending arrangements, given to the regulated entity by the clients concerned;
 - h. separate records of all such transactions sufficient to show the details of the stocks lent at any time and the collateral held;
 - i. proper segregation of duties which ensure each area is staffed by people independent of any other operations and password controls;
 - j. qualifications and experience of senior management;
 - k. 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;
 - l. regular stock reconciliations performed against third party supporting documents;
 - 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. 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 for collateral the intermediary):

- 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. written direction to withdraw client securities or securities collateral (where required under section 5);
- iii. standing authority, except where this will result in:
 - the transfer of client securities or securities collateral to an account in Hong Kong other than an account referred to in section 5;
 - result in a transfer of the client securities or securities collateral to an officer or employee, unless he is the client in question; or
 - be unconscionable in the sense of the Unconscionable Contracts Ordinance.

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

Where there is a liability owed by or on behalf of a client, with that client's written agreement, an intermediary 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 or registered for dealing in securities and their associated entities

With a standing authority a regulated entity licensed or registered for dealing in securities may:

- i. apply any of the securities or securities collateral pursuant to a securities borrowing or lending agreement;
- ii. 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 recognized clearing house or another intermediary as collateral for the discharge and satisfaction of the intermediary's settlement obligations and liabilities.

d. Section 8 – treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities

With a standing authority a regulated entity 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 intermediary.

e. Section 9 – treatment of securities collateral by intermediaries licensed or registered for dealing in futures contracts and their associated entities

With a standing authority a regulated entity licensed for dealing in futures contracts may deposit any of the securities collateral that it receives with a recognized clearing house or an intermediary licensed for dealing in futures contracts as collateral for the discharge and satisfaction of the intermediary'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; and
- d. transfers of client securities and securities collateral are made to appropriate authorized accounts.

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; and
 - 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.

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

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

The auditors 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 auditors 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 27 to 34 below); and
 - h. circularisation of account balances in accordance with paragraph 60 below.

Reconciliations

Control objectives – Reconciliation of client securities – Physically held client securities

27. 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

28. 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) within time limits set out in the rules.

Control objectives – Reconciliation of client securities – Client securities held by a custodian

29. 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;
- 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

30. 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) within time limits set out in the rules.

31. Where client securities are physically held by the regulated entity itself, the auditors 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 auditors consider the strength of controls surrounding, and the independence of, the count, reconciliation, day to day processing and custody of client documents of title.

32. The auditors examine confirmations from independent custodians of documents of title held by them.

33. The auditors inspect correspondence and agreements with custodians in order to verify compliance with the rules.

34. 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

35. 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 a licensed corporation, in relation to such conduct of the regulated activity.
36. 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.
37. 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.
38. For the particular regulated entity, the auditors need to understand what may constitute client money that is covered by the Client Money Rules. They 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 auditors need 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

39. When a regulated entity holds or expects to hold client money then 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

40. The auditors' 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 auditors, to enable them to fulfil their reporting requirements are:
 - a. whether during the period under review, the regulated entity had systems of control in place that were adequate to ensure compliance with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules;
 - b. whether during the period under review, the regulated entity has complied with sections 4, 5, 6, 8(4), 10 and 11 of the Client Money Rules; and
 - c. whether during the period under review, the regulated entity has complied with sections 3 and 4 of the Keeping of Records Rules to the extent that they relate to client money.
41. The control objectives that the auditors would expect to see in a regulated entity holding client money and the evidence from which the auditors seek 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)

42. 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

43. 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

44. 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

45. 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, client written directions, under a standing authority or in accordance with a client mandate.

Evidence – Payment of client money out of segregated accounts

46. The main factor that will be considered is:
- a. withdrawals 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)

47. 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

48. 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

49. 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 clients' written instructions;
 - b. schedules showing how interest due to clients has been calculated (or equivalent computer processes); and
 - c. interest credited to segregated accounts.

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

Control objectives – Timely renewal of standing authorities

50. 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

51. 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)

52. 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

53. The main factor that will be considered is:
- a. 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

54. The main factor that will be considered is:
- a. 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

55. 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

56. 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

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

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

The auditors 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

58. 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

59. 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 61 to 66 below);
 - e. the records maintained comply with the guidance given by the SFC; and
 - f. to provide third party evidence of client balances (except settlement balances), the auditors 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.

60. Auditors exercise their professional judgement to determine whether and how to go about the performance of a circularization of clients' account balances. In order to enhance consistency of audit procedures, the SFC has issued a list of matters which they consider worth highlighting for consideration regarding such a circularization of clients' account balances:
- a. auditors would exercise their judgement 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. confirmation would be prepared in language that the clients of the regulated entity are familiar with;
 - c. confirmation would be directly sent to and received from clients. Clients would be provided with convenient means of responding to the auditors;
 - d. be aware of any client enquiries regarding any discrepancies in their account balances;
 - e. auditors would independently select samples for circularization;
 - f. auditors 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
 - g. 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

61. The requirement to carry out reconciliations is set out in the Keeping of Records Rules.
62. All 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 its associated entities and other parties, including:
- a. recognized exchange companies;
 - b. clearing houses;
 - c. other intermediaries;
 - d. custodians; and
 - e. banks,
- and show how such differences were resolved.

Control objectives – Reconciliation

63. 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

64. The main factors that will be considered are:

ED/PN 820 (June 2003)

- a. an up-to-date list of the segregated accounts held that agrees with the segregated accounts being reconciled;
 - b. evidence of an independent preparation and review of these reconciliations; and
 - c. reconciliations being carried out regularly over the period under review.
65. The auditors carry 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 their substantive testing, the auditors examine and where appropriate obtain direct confirmation of bank balances from each bank concerned.
66. 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

67. The auditors must be alert to a situation where the regulated entity is not permitted under the terms of its authorization to hold client assets or does not, as a matter of policy, hold client assets. Where this is the case, the regulated entity would have systems in place to avoid receiving and holding client assets.
68. Although auditors are not required to give the SFC independent assurance that the regulated entity has not administered or held client assets, they still consider carrying out the following procedures:
 - a. enquire as to what arrangements a regulated entity 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 regulated entity's own money and that no client money is being received or held;
 - d. review the regulated entity'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 regulated entity 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 auditors or compliance officer and encompasses substantive review of the regulated entity's bank accounts and client agreements; and
 - g. enquire as to details of any client money the regulated entity has received and the action taken.
69. The auditors will consider obtaining written representations from management that the regulated entity has not breached any rules relating to the client assets during the period under review.