

## Audit of Licensed Corporations and Associated Entities of Intermediaries

The Questions and Answers (Q&As) below are developed by the Institute's Expert Panel on Securities to raise practising members' awareness of the common audit issues that may be encountered by auditors of licensed corporations and associated entities of intermediaries. They should be read in the light of applicable Hong Kong Standards on Auditing issued by the Institute and Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries".

This set of Q&As addresses some of the common issues and questions to be considered in the planning process and the practical procedures that can be applied to the audit of licensed corporations and associated entities of intermediaries.

The Expert Panel on Securities welcomes your comments and feedback, which should be sent to [commentletters@hkicpa.org.hk](mailto:commentletters@hkicpa.org.hk), for the attention of Patricia McBride, Executive Director.

**The Q&As are intended for general guidance only. The Institute and the Expert Panel on Securities DO NOT accept any responsibility or liability, and DISCLAIM all responsibility and liability, in respect of the Q&As and any consequences that may arise from any person acting or refraining from action as a result of any materials in the Q&As.**

**Q1: *What are the current Hong Kong Standards on Auditing (HKSA) and Practice Note relevant to the audit of licensed corporations and associated entities of intermediaries?***

A1: HKSA apply to the conduct of all audits. Auditors are therefore required to consider all HKSA to identify which Standards are applicable to the circumstances surrounding their audits of licensed corporations and associated entities of intermediaries.

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

- Developing an approach to the audit of the financial statements of licensed corporations and associated entities of intermediaries. This is dealt with in Part II of the PN;
- 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. This is dealt with in Part III of the PN;
- Completion of the Securities and Futures Commission's (SFC) Audit Questionnaire by the auditors. This is dealt with in Part IV of the PN; and
- Reporting directly to the SFC under the SFO. This is dealt with in Part V of the PN.

**Q2: PN 820 was issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) in February 2004 and all the Statements of Auditing Standards (SASs) referred to in Part II of the PN have been superseded by equivalent HKSAs. When will the HKICPA update this part to reflect the HKSAs?**

A2: The Institute's Expert Panel on Securities will be updating PN 820 during 2007 with a planned timeline to complete the task by the end of 2007. Practitioners are to note that all the guidance in Part II of the PN referring to SASs are still relevant as the guidance was written specifically for the Securities Industry. However, Practitioners should note that HKSAs apply to the conduct of their audits and should refer to the relevant HKSAs. Practitioners are to note that the requirements in HKSAs are more rigorous and robust.

**Q3: What are the key features of the HKSAs issued since the issuance of PN 820 in February 2004?**

A3: Many HKSAs have been issued since the issuance of PN 820 and it would be extremely difficult to cover all the key factors in a Q&A circular like this. The following list, which is not exhaustive, provides guidance in the application of certain HKSAs. This list is not an alternative to reading the relevant HKSAs in their entirety:

*Objective and general principles governing an audit of financial statements*

1. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
2. Auditing Standards include a requirement for auditors to comply with relevant ethical requirements relating to audit engagements contained in the HKICPA Code of Ethics for Professional Accountants. A fundamental principle is that practising members should not accept or perform work which they are not competent to undertake. Accordingly, the implication for practitioners is that they should not undertake the audit of licensed corporations unless they are satisfied that they have, or can obtain, the necessary level of competence.

*Quality control for audits of historical financial information*

3. The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and the regulatory and legal requirements of the SFO, and to enable an auditor's report and a compliance report that are appropriate in the circumstances to be issued.

*Documentation*

4. The auditor should prepare, on a timely basis, audit documentation that provides:
  - (a) A sufficient and appropriate record of the basis for the auditor's report; and

- (b) Evidence that the audit was performed in accordance with HKSAs and applicable legal and regulatory requirements
5. The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report. For audits of financial information for periods beginning on or after 15 June 2006, Hong Kong Standard on Quality Control 1 *Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* indicates 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which to complete the assembly of the final audit file.

*The auditor's responsibility to consider fraud in an audit of financial statements*

6. The auditor should maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.
7. The auditor's previous experience with the licensed corporation contributes to an understanding of the licensed corporation. However, although the auditor cannot be expected to fully disregard past experience with the licensed corporation about the honesty and integrity of management and those charged with governance, the maintenance of an attitude of professional skepticism is important because there may have been changes in circumstances. When making inquiries and performing other audit procedures, the auditor exercises professional skepticism and is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. With respect to those charged with governance, maintaining an attitude of professional skepticism means that the auditor carefully considers the reasonableness of responses to inquiries of those charged with governance, and other information obtained from them, in the light of all other evidence obtained during the audit.
8. Members of the engagement team should discuss the susceptibility of the licensed corporation's financial statements to material misstatement due to fraud. The appendices to HKSA 240 *The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements* set out some useful guidance on examples of fraud risk factors, examples of possible audit procedures to address the assessed risks of material misstatement due to fraud and examples of circumstances that indicate the possibility of fraud.
9. Clients' monies and securities are always fraud risk areas for consideration by auditors. Auditors are encouraged to circularize external confirmations of client account balances together with client assets held for custody so as to obtain audit evidence to support regulatory reporting items. Further details on circularization are set out in paragraph 27 of Appendix 2 of PN 820.

10. The auditor should also note that paragraph 110 of HKSA 240 requires that when the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reasons for that conclusion.

*Communication of audit matters with those charged with governance*

11. The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

*Planning an audit of financial statements*

12. Planning an audit is a continual and iterative process throughout the audit engagement. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan, and thereby the resulting planned nature, timing and extent of further audit procedures. Information may come to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

*Understanding the entity and its environment and assessing the risks of material misstatement*

13. The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures. Some guidance in this respect is provided in paragraphs 53 to 58 of PN 820.

*The auditor's procedures in response to assessed risks*

14. In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks and should design and perform further audit procedures to respond to the assessed risks.

*External confirmations*

15. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate evidence. The SFC views external confirmations as a strong auditing procedure and accordingly the SFC encourages an auditor of a licensed corporation to carry out such an exercise.
16. When an auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter like certain clients' monies or

securities, the auditor should apply alternative audit procedures to obtain appropriate audit evidence regarding that matter.

17. If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation of scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.

#### *Auditing fair value measurements and disclosures*

18. The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. The auditor should consider the need to use the work of an expert.

#### *Going concern*

19. The auditor should inquire of management as to its knowledge of events or conditions and related business risks beyond the period of assessment used by management that may cast significant doubt on the licensed corporation's ability to continue as a going concern. Going concern issues are also covered in paragraphs 44 and 45 of PN 820.

#### *Management representations*

20. An important principle in auditing is that representations by management cannot be a substitute for other audit evidence that the auditor expects to be available.
21. In addition to the examples of representations given in HKSA 580 *Management Representations*, paragraph 64 of PN 820 provides further guidance.

**Q4: *The new Audit Report Standard HKSA 700 "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" is effective for audit reports dated on or after 31 December 2006. Is there an example audit report for financial statements of a licensed corporation?***

A4: Appendix 1 sets out an example audit report for a licensed corporation based on HKSA 700 (effective for audit reports dated on or after 31 December 2006). For audit reports dated before 31 December 2006, example report 1 in appendix 1 of PN 820 applies.

As HKSA 700 does not govern compliance reports, the Expert Panel on Securities will review the example compliance report in PN 820 as part of the revision of PN 820. The example compliance report in PN 820 is still applicable for compliance reports dated on or after 31 December 2006 except that the reference to "Standards on Assurance Engagements" should be updated to refer to Hong Kong Standard on Assurance Engagements 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*.

Practitioners are to note that HKSA 701 *Modifications to the Independent Auditor's Report* establishes standards and provides guidance on the circumstances when the independent auditor's report should be modified and the form and the content of the modifications to the auditor's report. HKSA 701,

like HKSA 700, is effective for audit reports dated on or after 31 December 2006.

Date of Questions & Answers: 19 January 2007

## Appendix 1

**Example Unqualified Auditor's Report on Financial Statements of a Licensed Corporation carried out pursuant to PN 820****(Effective for audit reports dated on or after 31 December 2006)****INDEPENDENT AUDITOR'S REPORT****TO THE SHAREHOLDERS OF ABC SECURITIES LIMITED**(incorporated in Hong Kong with limited liability)<sup>1</sup>**Report on the Financial Statements**

We have audited the financial statements of ABC Securities Limited set out on pages ..... to..... , which comprise the balance sheet as at 31 December 200X, and the income statement, [statement of changes in equity or statement of recognised income and expense] and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Directors' responsibility for the financial statements*

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

*Auditor's responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>2</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 820 "The audit of licensed corporations and associated entities of intermediaries" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement, 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 audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk

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

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

assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

#### *Opinion*

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 200X and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

#### **Report on matters under the Securities and Futures (Keeping of Records) Rules of the Securities and Futures Ordinance**

In our opinion, 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.

XYZ & Co.

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

[Address]

Date