

# MEMBERS' HANDBOOK

## Update No. 49

(Issued March 2008)

<i>Document Reference and Title</i>	<i>Instructions</i>	<i>Explanations</i>
<b>VOLUME III</b>		
Contents of Volume III	Discard the existing pages i, ii and iii and replace with new pages i, ii and iii.	Revised contents pages

## **HONG KONG STANDARDS ON REVIEW ENGAGEMENTS (HKSREs 2000-2699)**

HKSRE 2400 <i>Engagements to Review Financial Statements</i>	Insert revised pages 1 to 17 and discard the replaced pages 1 to 17.	Revised HKSRE (Note 1)
HKSRE 2410 <i>Review of Interim Financial Information Performed by the Independent Auditor of the Entity</i>	Insert revised pages 1-4, 21, 23, 26 and 29. Discard the replaced pages 1-4, 21, 23, 26 and 29.	Revised HKSRE (Note 2)

## **PRACTICE NOTES**

Practice Note 820 <i>The Audit of Licensed Corporations and Associated Entities of Intermediaries</i>	Insert revised pages 1-62 and discard the replaced pages 1-60.	Revised Practice Note (Note 3)
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### Notes:

- HKSRE 2400 - Paragraph 2 is revised to provide further clarification that HKSRE 2400 is directed towards the review of financial statements by a practitioner, who is not the auditor of an entity. However, it is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information.

Previous mark-up changes due to a revision in March 2007 have been accepted in this document and hence the whole document is reissued.

2. HKSRE 2410 - The scope of this HKSRE is directed towards a review of interim financial information performed by the independent auditor of the financial statements of the entity. However, as a result of the amendments (paragraph 3a), it is to be applied, adapted as necessary in the circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than interim financial information of an audit client.
3. PN 820 has been revised in the following aspects:
  - Updated Part II to reflect the new Hong Kong Standards on Auditing replacing Statements of Auditing Standards ("SASs").
  - Restructured Part III to separate guidance regarding management and auditor's responsibilities for greater clarity.
  - Updated example auditor's report in line with HKSA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, details of which were also available in the HKICPA Circular dated 19 January 2007.
  - Deletion of certain references to Auditing Standards in Part II of the extant PN 820, where it was considered that the extant guidance were merely generic guidance applicable to all audits, e.g., SAS 420 *Auditing of accounting estimates*, SAS 500A *Considering the work of internal auditing*, SAS 520 *Using the work of an expert*.
  - Deletion of examples 1A and 2A of Appendix 1 relating to straddle reports, which are no longer applicable.

In addition to the above, there are some detailed improvement changes developed in consultation with the SFC, which include paragraphs 33, 45, 49, 55, 64, 68 and 122 of the PN, and the following guidance:

- Guidance on deposit or registration of client securities and securities collateral (Appendix 2 – paragraph 18(l)).
- Guidance on the new requirement of repledging limit (Appendix 2 – paragraphs 19(e), 20(e) and 21(h)).
- Additional guidance on performance of a circularisation of clients' account balances (Appendix 2 – paragraphs 27(b), 27(c), 27(h) and 27(i)).



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Effective upon issue

*Hong Kong Standard on Review Engagements 2400*

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# Engagements to Review Financial Statements

1. HKSRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued in March 2007 gave rise to conforming amendments to HKSRE 2400. These amendments are effective for reviews of financial statements for periods beginning on or after 15 December 2006 unless HKSRE 2410 is early adopted. Early adoption of HKSRE 2410 is permissible. The amendments have been incorporated in the text of this HKSRE.

For reporting purposes under the Main Board Listing Rules and GEM Listing Rules of the Stock Exchange of Hong Kong Limited, practitioners who are not the auditor of the entity and are performing a review in accordance with HKSRE 2400 may refer to the example review reports set out in HKSRE 2410.

2. Paragraph 2 is revised on March 2008 (marked-up) to provide further clarification that HKSRE 2400 is directed towards the review of financial statements. However, it is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information. Early adoption is permissible.



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

**HONG KONG STANDARD ON REVIEW ENGAGEMENTS 2400  
ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS**

(Effective upon issue ~~and~~, revised March 2007 and March 2008)

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Hong Kong Standard on Review Engagements (HKSRE) 2400, "Engagements to Review Financial Statements" should be read in the context of the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services" which sets out the application and authority of HKSREs.

## Introduction

1. The purpose of this Hong Kong Standard on Review Engagements (HKSRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review. A practitioner, who is the auditor of the entity, engaged to perform a review of interim financial information performs such a review in accordance with HKSRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity".
2. This HKSRE is directed towards the review of financial statements. However, it is to be applied, ~~adapted as necessary in the circumstances, to the extent practicable~~ to engagements to review other historical financial ~~or other~~ information. This HKSRE is to be read in conjunction with the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services". Guidance in other HKSREs may be useful to the practitioner in applying this HKSRE.

## Objective of a Review Engagement

3. **The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance).**

## General Principles of a Review Engagement

4. **The practitioner should comply with the HKICPA Statements of Professional Ethics/Code of Ethics for Professional Accountants.** Ethical principles governing the practitioner's professional responsibilities are:
  - (a) Independence;
  - (b) Integrity;
  - (c) Objectivity;
  - (d) Professional competence and due care;
  - (e) Confidentiality;
  - (f) Professional behaviour; and
  - (g) Technical standards.
5. **The practitioner should conduct a review in accordance with this HKSRE.**
6. **The practitioner should plan and perform the review with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated.**
7. **For the purpose of expressing negative assurance in the review report, the practitioner should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.**

## Scope of a Review

8. The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. **The procedures required to conduct a review of financial statements should be determined by the practitioner having regard to the requirements of this HKSRE, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.**

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<sup>1</sup> Not used.



## Moderate Assurance

9. A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement, this is expressed in the form of negative assurance.

## Terms of Engagement

10. **The practitioner and the client should agree on the terms of the engagement.** The agreed terms would be recorded in an engagement letter or other suitable form such as a contract.
11. An engagement letter will be of assistance in planning the review work. It is in the interests of both the practitioner and the client that the practitioner sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the practitioner's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the practitioner's responsibilities and the form of reports to be issued.
12. Matters that would be included in the engagement letter include the following:
  - The objective of the service being performed.
  - Management's responsibility for the financial statements.
  - The scope of the review, including reference to this HKSRE.
  - Unrestricted access to whatever records, documentation and other information requested in connection with the review.
  - A sample of the report expected to be rendered.
  - The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
  - A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasize this point and to avoid confusion, the practitioner may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of financial statements appears in Appendix 1 to this HKSRE.

## Planning

13. **The practitioner should plan the work so that an effective engagement will be performed.**
14. **In planning a review of financial statements, the practitioner should obtain or update the knowledge of the business including consideration of the entity's organization, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.**
15. The practitioner needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, a knowledge of the entity's production and distribution methods, product lines, operating locations and related parties. The practitioner requires this understanding to be able to make relevant inquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

## Work Performed by Others

16. **When using work performed by another practitioner or an expert, the practitioner should be satisfied that such work is adequate for the purposes of the review.**

## Documentation

17. **The practitioner should document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with this HKSRE.**

## Procedures and Evidence

18. **The practitioner should apply judgment in determining the specific nature, timing and extent of review procedures.** The practitioner will be guided by such matters as the following:

- Any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
- The practitioner's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
- The entity's accounting systems.
- The extent to which a particular item is affected by management judgment.
- The materiality of transactions and account balances.

19. **The practitioner should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given.** Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgment as to what is material is made by reference to the information on which the practitioner is reporting and the needs of those relying on that information, not to the level of assurance provided.

20. Procedures for the review of financial statements will ordinarily include the following:

- Obtaining an understanding of the entity's business and the industry in which it operates.
- Inquiries concerning the entity's accounting principles and practices.
- Inquiries concerning the entity's procedures for recording, classifying and summarizing transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
- Inquiries concerning all material assertions in the financial statements.
- Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
  - Comparison of the financial statements with statements for prior periods.
  - Comparison of the financial statements with anticipated results and financial position.
  - Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

In applying these procedures, the practitioner would consider the types of matters that required accounting adjustments in prior periods.

- Inquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.
- Reading the financial statements to consider, on the basis of information coming to the practitioner's attention, whether the financial statements appear to conform with the basis of accounting indicated.
- Obtaining reports from other practitioners, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.

- Inquiries of persons having responsibility for financial and accounting matters concerning, for example:
  - Whether all transactions have been recorded.
  - Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
  - Changes in the entity's business activities and accounting principles and practices.
  - Matters as to which questions have arisen in the course of applying the foregoing procedures.
  - Obtaining written representations from management when considered appropriate.

Appendix 2 to this HKSRE provides an illustrative list of procedures which are often used. The list is not exhaustive, nor is it intended that all the procedures suggested apply to every review engagement.

21. **The practitioner should inquire about events subsequent to the date of the financial statements that may require adjustment of or disclosure in the financial statements.** The practitioner does not have any responsibility to perform procedures to identify events occurring after the date of the review report.
22. **If the practitioner has reason to believe that the information subject to review may be materially misstated, the practitioner should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.**

## Conclusions and Reporting

23. **The review report should contain a clear written expression of negative assurance. The practitioner should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.**
24. **Based on the work performed, the practitioner should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the identified financial reporting framework.**
25. The report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.
26. **The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:**
  - (a) **Title ;<sup>2</sup>**
  - (b) **Addressee;**
  - (c) **Opening or introductory paragraph including:**
    - (i) **Identification of the financial statements on which the review has been performed; and**
    - (ii) **A statement of the responsibility of the entity's management and the responsibility of the practitioner;**
  - (d) **Scope paragraph, describing the nature of a review, including:**
    - (i) **A reference to this HKSRE;**

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<sup>2</sup> It may be appropriate to use the term "Independent" in the title to distinguish the practitioner's report from reports that might be issued by others, such as officers of the entity, or from the reports of other practitioners who may not have to abide by the same ethical requirements as an independent practitioner.

- (ii) **A statement that a review is limited primarily to inquiries and analytical procedures; and**
- (iii) **A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;**
- (e) **Statement of negative assurance;**
- (f) **Date of the report;**
- (g) **Practitioner's address; and**
- (h) **Practitioner's signature.**

Appendices 3 and 4 to this HKSRE contain illustrations of review reports.

**27. The review report should:**

- (a) **State that nothing has come to the practitioner's attention based on the review that causes the practitioner to believe the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the identified financial reporting framework (negative assurance); or**
- (b) **If matters have come to the practitioner's attention, describe those matters that impair a true and fair view (or a fair presentation, in all material respects) in accordance with the identified financial reporting framework, including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:**
  - (i) **Express a qualification of the negative assurance provided; or**
  - (ii) **When the effect of the matter is so material and pervasive to the financial statements that the practitioner concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the identified financial reporting framework; or**
- (c) **If there has been a material scope limitation, describe the limitation and either:**
  - (i) **Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or**
  - (ii) **When the possible effect of the limitation is so significant and pervasive that the practitioner concludes that no level of assurance can be provided, not provide any assurance.**

**28. The practitioner should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since the practitioner's responsibility is to report on the financial statements as prepared and presented by management, the practitioner should not date the review report earlier than the date on which the financial statements were approved by management.**

**Effective Date**

**29. This HKSRE is effective upon issue.**

## **Conformity and Compliance with International Standards on Review Engagements**

30. As of June 2005 (date of issue), this HKSRE conforms with International Standard on Review Engagements (ISRE) 2400, "Engagements to Review Financial Statements" except that a reference to IFAC Code of Ethics for Professional Accountants is replaced by HKICPA Statements of Professional Ethics/*Code of Ethics for Professional Accountants*. With the exception of the foregoing difference, compliance with the requirements of this HKSRE ensures compliance with ISRE 2400.
31. Additional local guidance is provided in footnote 3a of Appendix 1.

## Appendix 1

### Example of an Engagement Letter for a Review of Financial Statements

The following letter is for use as a guide in conjunction with the consideration outlined in paragraph 10 of this HKSRE and will need to be varied according to individual requirements and circumstances<sup>3a</sup>.

To the Board of Directors (or the appropriate representative of senior management):

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the balance sheet of XYZ Company as of 31 December 20XX, and the related statements of income and cash flows for the year then ended, in accordance with Hong Kong Standard on Review Engagements (HKSRE) 2400 “Engagements to Review Financial Statements” issued by the Hong Kong Institute of Certified Public Accountants. We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(see Appendix 3 to this HKSRE)

Responsibility for the financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. (As part of our review process, we will request written representations from management concerning assertions made in connection with the review<sup>3</sup>.)

This letter will be effective for future years unless it is terminated, amended or superseded (if applicable).

Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our review of the financial statements.

ABC & Co

Acknowledged on behalf of XYZ Company by

( signed )

.....

Name and Title

Date

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<sup>3</sup> This sentence should be used at the discretion of the practitioner.

<sup>3a</sup> The practitioner may consider it appropriate to include a limitation of liability clause in accordance with his firm’s risk management policies.

**Appendix 2****Illustrative Detailed Procedures That May be Performed in an Engagement to Review Financial Statements**

1. The inquiry and analytical review procedures carried out in a review of financial statements are determined by the practitioner's judgment. The procedures listed below are for illustrative purposes only. It is not intended that all the procedures suggested apply to every review engagement. This Appendix is not intended to serve as a program or checklist in the conduct of a review.

**General**

2. Discuss terms and scope of the engagement with the client and the engagement team.
3. Prepare an engagement letter setting forth the terms and scope of the engagement.
4. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.
5. Inquire whether all financial information is recorded:
  - (a) Completely;
  - (b) Promptly; and
  - (c) After the necessary authorization.
6. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
7. Consider the results of previous audits and review engagements, including accounting adjustments required.
8. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).
9. Inquire about the accounting policies and consider whether:
  - (a) They comply with local or international standards;
  - (b) They have been applied appropriately; and
  - (c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
10. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.
11. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.
12. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.
13. Inquire about contingencies and commitments.
14. Inquire about plans to dispose of major assets or business segments.
15. Obtain the financial statements and discuss them with management.
16. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.
17. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.

18. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.
19. Consider the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.
20. Consider obtaining a representation letter from management.

**Cash**

21. Obtain the bank reconciliations. Inquire about any old or unusual reconciling items with client personnel.
22. Inquire about transfers between cash accounts for the period before and after the review date.
23. Inquire whether there are any restrictions on cash accounts.

**Receivables**

24. Inquire about the accounting policies for initially recording trade receivables and determine whether any allowances are given on such transactions.
25. Obtain a schedule of receivables and determine whether the total agrees with the trial balance.
26. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
27. Obtain an aged analysis of the trade receivables. Inquire about the reason for unusually large accounts, credit balances on accounts or any other unusual balances and inquire about the collectibility of receivables.
28. Discuss with management the classification of receivables, including noncurrent balances, net credit balances and amounts due from shareholders, directors and other related parties in the financial statements.
29. Inquire about the method for identifying “slow payment” accounts and setting allowances for doubtful accounts and consider it for reasonableness.
30. Inquire whether receivables have been pledged, factored or discounted.
31. Inquire about procedures applied to ensure that a proper cutoff of sales transactions and sales returns has been achieved.
32. Inquire whether accounts represent goods shipped on consignment and, if so, whether adjustments have been made to reverse these transactions and include the goods in inventory.
33. Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made for such amounts.

**Inventories**

34. Obtain the inventory list and determine whether:
  - (a) The total agrees with the balance in the trial balance; and
  - (b) The list is based on a physical count of inventory.
35. Inquire about the method for counting inventory.
36. Where a physical count was not carried out on the balance sheet date, inquire whether:
  - (a) A perpetual inventory system is used and whether periodic comparisons are made with actual quantities on hand; and
  - (b) An integrated cost system is used and whether it has produced reliable information in the past.



37. Discuss adjustments made resulting from the last physical inventory count.
38. Inquire about procedures applied to control cutoff and any inventory movements.
39. Inquire about the basis used in valuing each category of the inventory and, in particular, regarding the elimination of inter-branch profits. Inquire whether inventory is valued at the lower of cost and net realizable value.
40. Consider the consistency with which inventory valuation methods have been applied, including factors such as material, labour and overhead.
41. Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.
42. Compare inventory turnover with that in previous periods.
43. Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realizable value.
44. Inquire whether any of the inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.
45. Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.

**Investments (Including Associated Companies and Marketable Securities)**

46. Obtain a schedule of the investments at the balance sheet date and determine whether it agrees with the trial balance.
47. Inquire about the accounting policy applied to investments.
48. Inquire from management about the carrying values of investments. Consider whether there are any realization problems.
49. Consider whether there has been proper accounting for gains and losses and investment income.
50. Inquire about the classification of long-term and short-term investments.

**Property and Depreciation**

51. Obtain a schedule of the property indicating the cost and accumulated depreciation and determine whether it agrees with the trial balance.
52. Inquire about the accounting policy applied regarding the provision for depreciation and distinguishing between capital and maintenance items. Consider whether the property has suffered a material, permanent impairment in value.
53. Discuss with management the additions and deletions to property accounts and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.
54. Inquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior years.
55. Inquire whether there are any liens on the property.
56. Discuss whether lease agreements have been properly reflected in the financial statements in conformity with current accounting pronouncements.

**Prepaid Expenses, Intangibles and Other Assets**

57. Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof.
58. Inquire about the basis for recording these accounts and the amortization methods used.

59. Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.
60. Discuss the classification between long-term and short-term accounts with management.

**Loans Payable**

61. Obtain from management a schedule of loans payable and determine whether the total agrees with the trial balance.
62. Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.
63. Consider the reasonableness of interest expense in relation to loan balances.
64. Inquire whether loans payable are secured.
65. Inquire whether loans payable have been classified between noncurrent and current.

**Trade Payables**

66. Inquire about the accounting policies for initially recording trade payables and whether the entity is entitled to any allowances given on such transactions.
67. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
68. Obtain a schedule of trade payables and determine whether the total agrees with the trial balance.
69. Inquire whether balances are reconciled with the creditors' statements and compare with prior period balances. Compare turnover with prior periods.
70. Consider whether there could be material unrecorded liabilities.
71. Inquire whether payables to shareholders, directors and other related parties are separately disclosed.

**Accrued and Contingent Liabilities**

72. Obtain a schedule of the accrued liabilities and determine whether the total agrees with the trial balance.
73. Compare major balances of related expense accounts with similar accounts for prior periods.
74. Inquire about approvals for such accruals, terms of payment, compliance with terms, collateral and classification.
75. Inquire about the method for determining accrued liabilities.
76. Inquire as to the nature of amounts included in contingent liabilities and commitments.
77. Inquire whether any actual or contingent liabilities exist which have not been recorded in the accounts. If so, discuss with management whether provisions need to be made in the accounts or whether disclosure should be made in the notes to the financial statements.

**Income and Other Taxes**

78. Inquire from management if there were any events, including disputes with taxation authorities, which could have a significant effect on the taxes payable by the entity.
79. Consider the tax expense in relation to the entity's income for the period.
80. Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including provisions in respect of prior periods.

### **Subsequent Events**

81. Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.
82. Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:
  - (a) Any substantial commitments or uncertainties have arisen subsequent to the balance sheet date;
  - (b) Any significant changes in the share capital, long-term debt or working capital have occurred up to the date of inquiry; and
  - (c) Any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.

Consider the need for adjustments or disclosure in the financial statements.

83. Obtain and read the minutes of meetings of shareholders, directors and appropriate committees subsequent to the balance sheet date.

### **Litigation**

84. Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process. Consider the effect thereof on the financial statements.

### **Equity**

85. Obtain and consider a schedule of the transactions in the equity accounts, including new issues, retirements and dividends.
86. Inquire whether there are any restrictions on retained earnings or other equity accounts.

### **Operations**

87. Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.
88. Discuss whether the recognition of major sales and expenses have taken place in the appropriate periods.
89. Consider extraordinary and unusual items.
90. Consider and discuss with management the relationship between related items in the revenue account and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the practitioner.

**Form of Unqualified Review Report**

REVIEW REPORT TO ...

We have reviewed the accompanying balance sheet of XYZ Company at 31 December 20XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2400 "Engagements to Review Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with Hong Kong Financial Reporting Standards<sup>4</sup>.

PRACTITIONER

Date  
Address

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<sup>4</sup> or indicate International Financial Reporting Standards.

**Examples of Review Reports Other Than Unqualified****Qualification for a Departure From Hong Kong Financial Reporting Standards**

## REVIEW REPORT TO ...

We have reviewed the accompanying balance sheet of XYZ Company at 31 December 20XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2400 "Engagements to Review Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit, and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost which is in excess of its net realizable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realizable value as required by Hong Kong Financial Reporting Standards<sup>5</sup>, would have been decreased by \$X, and net income and shareholders' equity would have been decreased by \$Y.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with Hong Kong Financial Reporting Standards<sup>5</sup>.

PRACTITIONER

Date  
Address

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<sup>5</sup> See footnote 4.

**Adverse Report for a Departure From Hong Kong Financial Reporting Standards**

REVIEW REPORT TO .....

We have reviewed the balance sheet of XYZ Company at 31 December 20XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2400 "Engagements to Review Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in footnote X, these financial statements do not reflect the consolidation of the financial statements of subsidiary companies, the investment in which is accounted for on a cost basis. Under Hong Kong Financial Reporting Standards<sup>6</sup> the financial statements of the subsidiaries are required to be consolidated.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with Hong Kong Financial Reporting Standards<sup>6</sup>

PRACTITIONER

Date  
Address

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<sup>6</sup> See footnote 4.

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Effective for reviews of interim financial information  
for periods beginning on or after 15 December 2006

*Hong Kong Standard on Review Engagements 2410*

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# Review of Interim Financial Information Performed by the Independent Auditor of the Entity

1. The scope of this HKSRE is ~~limited to~~ directed towards a review of interim financial information performed by the independent auditor of the financial statements of the entity, effective for reviews of interim financial information for periods beginning on or after 15 December 2006. However, as a result of the amendments (paragraph 3a), it is to be applied, adapted as necessary in the circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than interim financial information of an audit client.
2. A practitioner who is engaged to perform a review of interim financial information for periods beginning on or after 15 December 2006, and who is not the auditor of the entity, performs the review in accordance with HKSRE 2400, "Engagements to Review Financial Statements" and not this HKSRE.
3. SAS 700 "Engagements to review interim financial reports" is applicable for reviews of interim financial information for periods beginning before 15 December 2006. However, practitioners are to note that early adoption of this HKSRE is permissible.
4. The amendments in paragraph 3a and the examples of review reports in the Appendices are effective from March 2008, that is, they apply to review engagements commenced by a practitioner on or after the date of publication of these amendments. Early adoption is permissible.



**HONG KONG STANDARD ON REVIEW ENGAGEMENTS 2410**  
**REVIEW OF INTERIM FINANCIAL INFORMATION**  
**PERFORMED BY THE INDEPENDENT AUDITOR OF THE ENTITY**

(Effective for reviews of interim financial information for periods beginning on or after 15 December 2006. Earlier adoption is permissible)\*

(Issued March 2007 and Revised March 2008)

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Hong Kong Standard on Review Engagements (HKSRE) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" should be read in the context of the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services" which sets out the application and authority of HKSREs.

\* HKSRE 2410 gave rise to a conforming amendment to HKSA 210 "Terms of Audit Engagements" that are effective for audits of financial statements for periods beginning on or after 15 December 2006. It also gave rise to conforming amendments to HKSRE 2400 "Engagements to Review Financial Statements" that are effective for reviews of financial statements for periods beginning on or after 15 December 2006. These amendments are highlighted in the appendices to HKSA 210 and HKSRE 2400. Early adoption of HKSRE 2410 requires early adoption of the conforming amendments to HKSA 210 and HKSRE 2400.



## Introduction

1. The purpose of this Hong Kong Standard on Review Engagements (HKSRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this HKSRE, not because the auditor is performing an audit function but because the scope of this HKSRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.
  2. For purposes of this HKSRE, interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework<sup>1</sup> and comprises either a complete or a condensed<sup>1a</sup> set of financial statements for a period that is shorter than the entity's financial year.
  3. **The auditor who is engaged to perform a review of interim financial information should perform the review in accordance with this HKSRE.** Through performing the audit of the annual financial statements, the auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the interim financial information, this understanding is updated through inquiries made in the course of the review, and assists the auditor in focusing the inquiries to be made and the analytical and other review procedures to be applied. A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs the review in accordance with HKSRE 2400, "Engagements to Review Financial Statements." As the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal control, as the auditor of the entity, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review<sup>1b</sup>.
- 3a. This HKSRE is directed towards a review of interim financial information by an entity's auditor. However, it is to be applied, adapted as necessary in the circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than interim financial information of an audit client.

## General Principles of a Review of Interim Financial Information

4. **The auditor should comply with the ethical requirements relevant to the audit of the annual financial statements of the entity.** These ethical requirements govern the auditor's professional responsibilities in the following areas: independence, integrity, objectivity, professional competence and due care, confidentiality, professional behavior, and technical standards.
5. **The auditor should implement quality control procedures that are applicable to the individual engagement.** The elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and specific engagements, assignment of engagement teams, engagement performance, and monitoring.

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<sup>1</sup> For example, Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.

<sup>1a</sup> In Hong Kong, the Main Board Listing Rules and GEM Listing Rules require a listed issuer to prepare an interim report or a half-year report in respect of the first six months of its financial year.

A listed issuer that prepares its annual financial statements in accordance with Hong Kong Financial Reporting Standards is required to comply with Hong Kong Accounting Standard (HKAS) 34 "Interim Financial Reporting" in respect of its interim report or its half-year report. As HKAS 34 allows an entity to provide "condensed" financial statements in its interim financial report or comprehensive information in a complete set of financial statements (as described in HKAS 1 "Presentation of Financial Statements"), listed issuers in Hong Kong normally prepare "condensed" financial statements.

For reporting on "condensed" financial statements, paragraph 43(j) of this HKSRE is applicable instead of paragraph 43(i).

<sup>1b</sup> For reporting purposes under the Main Board Listing Rules and GEM Listing Rules, practitioners who are not the auditor of the entity and are performing a review in accordance with HKSRE 2400 may refer to the example review reports set out in this HKSRE.

6. **The auditor should plan and perform the review with an attitude of professional skepticism, recognizing that circumstances may exist that cause the interim financial information to require a material adjustment for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.** An attitude of professional skepticism means that the auditor makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by management of the entity.

### **Objective of an Engagement to Review Interim Financial Information**

7. The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.
8. The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with Hong Kong Standards on Auditing (HKSAAs). A review of interim financial information does not provide a basis for expressing an opinion whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with an applicable financial reporting framework.
9. A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

### **Agreeing the Terms of the Engagement**

10. **The auditor and the client should agree on the terms of the engagement.**
11. The agreed terms of the engagement are ordinarily recorded in an engagement letter. Such a communication helps to avoid misunderstandings regarding the nature of the engagement and, in particular, the objective and scope of the review, management's responsibilities, the extent of the auditor's responsibilities, the assurance obtained, and the nature and form of the report. The communication ordinarily covers the following matters:
  - The objective of a review of interim financial information.
  - The scope of the review.
  - Management's responsibility for the interim financial information.
  - Management's responsibility for establishing and maintaining effective internal control relevant to the preparation of interim financial information.
  - Management's responsibility for making all financial records and related information available to the auditor.
  - Management's agreement to provide written representations to the auditor to confirm representations made orally during the review, as well as representations that are implicit in the entity's records.
  - The anticipated form and content of the report to be issued, including the identity of the addressee of the report.
  - Management's agreement that where any document containing interim financial information indicates that the interim financial information has been reviewed by the entity's auditor, the review report will also be included in the document.

An illustrative engagement letter is set out in Appendix 1 to this HKSRE. The terms of engagement to review interim financial information can also be combined with the terms of engagement to audit the annual financial statements.

## Appendix 4

## Examples of Review Reports on Interim Financial Information

**Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))**

## Report on Review of Interim Financial Information

(Appropriate addressee)

*Introduction*

We have reviewed the interim financial statements set out on pages .... to ....., which comprise the balance sheet of ABC Entity as of 31 March 200X and the related statements of income, changes in equity and cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes<sup>3</sup>. [The (Main Board Listing Rules or GEM Listing Rules) Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of a report on interim financial information to be in compliance with the relevant provisions thereof and Hong Kong Accounting Standard 34 "Interim Financial Reporting" issued by the Hong Kong Institute of Certified Public Accountants/International Accounting Standard 34 "Interim Financial Reporting"]<sup>\*</sup>. The directors are responsible for the preparation and fair presentation of this interim financial statements in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial statements based on our review<sup>3a</sup>.

*Scope of Review*

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants.<sup>\*\*</sup> A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

*Conclusion*

Based on our review, nothing has come to our attention that causes us to believe that the interim financial statements does not give a true and fair view of (or "does not present fairly, in all material respects,") the financial position of the entity as at 31 March 200X, and of its financial performance and its cash flows for the six-month period then ended in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards].

AUDITOR

Date

Address

<sup>3</sup> The auditor may wish to specify the regulatory authority or equivalent with whom the interim financial information is filed.

<sup>\*</sup> Delete where not applicable.

<sup>3a</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".

<sup>\*\*</sup> In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

## Appendix 5

## Examples of Review Reports with a Qualified Conclusion for a Departure from the Applicable Financial Reporting Framework

### Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

#### Report on Review of Interim Financial Information

(Appropriate addressee)

#### *Introduction*

We have reviewed the interim financial statements set out on pages .... to ....., which comprise the balance sheet of ABC Entity as of 31 March 200X and the related statements of income, changes in equity and cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes<sup>5</sup>. [The (Main Board Listing Rules or GEM Listing Rules) Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of a report on interim financial information to be in compliance with the relevant provisions thereof and Hong Kong Accounting Standard 34 "Interim Financial Reporting" issued by the Hong Kong Institute of Certified Public Accountants/International Accounting Standard 34 "Interim Financial Reporting"]\*. The directors are responsible for the preparation and fair presentation of this interim financial statements in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial statements based on our review<sup>5a</sup>.

#### *Scope of Review*

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants.\*\* A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

#### *Basis for Qualified Conclusion*

Based on information provided to us by the directors, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalized to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalized at 31 March 200X, property would be increased by \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_, and net income and earnings per share (basic and diluted) would be increased (decreased) by \$\_\_\_\_\_, \$\_\_\_\_\_, and \$\_\_\_\_\_, respectively, for the six-month period then ended.

<sup>5</sup> The auditor may wish to specify the regulatory authority or equivalent with whom the interim financial information is filed.  
\* Delete where not applicable.

<sup>5a</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".

\*\* In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

## Appendix 6

**Examples of Review Reports with a Qualified Conclusion for a Limitation on Scope Not Imposed By Management****Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))**

## Report on Review of Interim Financial Information

(Appropriate addressee)

*Introduction*

We have reviewed the interim financial statements set out on pages .... to ....., which comprise the balance sheet of ABC Entity as of 31 March 200X and the related statements of income, changes in equity and cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes<sup>7</sup>. [The (Main Board Listing Rules or GEM Listing Rules) Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of a report on interim financial information to be in compliance with the relevant provisions thereof and Hong Kong Accounting Standard 34 "Interim Financial Reporting" issued by the Hong Kong Institute of Certified Public Accountants/International Accounting Standard 34 "Interim Financial Reporting"]<sup>\*</sup>. The directors are responsible for the preparation and fair presentation of this interim financial statements in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial statements based on our review<sup>7a</sup>.

*Scope of Review*

Except as explained in the following paragraph, we conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants.<sup>\*\*</sup> A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

*Basis for Qualified Conclusion*

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totalling \$\_\_\_\_\_ included in the interim financial statements. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above and the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial statements.

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<sup>7</sup> The auditor may wish to specify the regulatory authority or equivalent with whom the interim financial information is filed.

\* Delete where not applicable.

<sup>7a</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".

<sup>\*\*</sup> In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

## Appendix 7

## Examples of Review Reports with an Adverse Conclusion for a Departure from the Applicable Financial Reporting Framework

### Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

#### *Introduction*

We have reviewed the interim financial statements set out on pages .... to ....., which comprise the balance sheet of ABC Entity as of 31 March 200X and the related statements of income, changes in equity and cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes<sup>9</sup>. [The (Main Board Listing Rules or GEM Listing Rules) Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of a report on interim financial information to be in compliance with the relevant provisions thereof and Hong Kong Accounting Standard 34 "Interim Financial Reporting" issued by the Hong Kong Institute of Certified Public Accountants/International Accounting Standard 34 "Interim Financial Reporting"]<sup>\*</sup>. The directors are responsible for the preparation and fair presentation of this interim financial statements in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial statements based on our review<sup>9a</sup>.

#### *Scope of Review*

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants.<sup>\*\*</sup> A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

#### *Basis for Adverse Conclusion*

Commencing this period, the directors of the entity ceased to consolidate the financial statements of its subsidiary companies since the directors consider consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards]. Had consolidated financial statements been prepared, virtually every account in the interim financial statements would have been materially different.

<sup>9</sup> The auditor may wish to specify the regulatory authority or equivalent with whom the interim financial information is filed.

\* Delete where not applicable.

<sup>9a</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".

<sup>\*\*</sup> In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

Effective upon issue

*Practice Note 820*

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# **The Auditors of Licensed Corporations and Associated Entities of Intermediaries**



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

**PRACTICE NOTE  
820  
THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES**

*(Issued February 2004; revised September 2004 (name change), and revised March 2008)*

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**PRACTICE NOTE**  
**820**  
**THE AUDIT OF LICENSED CORPORATIONS AND**  
**ASSOCIATED ENTITIES OF INTERMEDIARIES**

*The purpose of Practice Notes issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) is to assist the auditor in applying Hong Kong Standards on Auditing (HKSAAs) and Hong Kong Standards on Assurance Engagements (HKSAEs) of general application to particular circumstances and industries.*

*Practice Notes are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in HKSAAs and HKSAEs, even though they may be developed without the full process of consultation and exposure used for HKSAAs and HKSAEs. The auditor should be prepared to explain departures when called upon to do so.*

**PART I - GENERAL**

**Introduction**

1. The purpose of this Practice Note is to assist the auditor to develop an approach to the audit of the financial statements of licensed corporations and associated entities of intermediaries. This is dealt with in Part II.
2. This Practice Note also provides guidance on the auditor's other reporting responsibilities under the Securities and Futures Ordinance (SFO) which are set out in the Securities and Futures (Accounts and Audit) Rules. This is dealt with in Part III.
3. Guidance on the completion of the Securities and Futures Commission's (SFC) Audit Questionnaire by the auditor is set out in Part IV.
4. The auditor is entitled under the SFO to report directly to the SFC in exceptional circumstances and, in some cases, has a duty to do so. Guidance on such ad hoc reporting is set out in Part V.
5. This Practice Note has been prepared in consultation with the SFC.
6. This Practice Note is based on the SFO in effect as at 1 April 2003, and the subsidiary legislation, codes and guidelines issued by the SFC up to 1 August 2007. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this Practice Note should be used in conjunction with the legislation.
7. It should be borne in mind that certain expressions used in the SFO may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this Practice Note, the auditor will wish to seek legal advice.

**Definitions**

8. The definitions used in this Practice Note are:

- a. *Associated entity*

A company that is in a controlling entity relationship with an intermediary and receives or holds in Hong Kong client assets of the intermediary.

- b. *Client assets*  
As defined in section 1 in Schedule 1 of the SFO.
- c. *Client asset rules*  
Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules.
- d. *Codes and guidelines*  
Codes and guidelines issued by the SFC under the SFO.
- e. *FRR*  
Securities and Futures (Financial Resources) Rules.
- f. *Intermediary*  
A licensed corporation or a registered institution.
- g. *Internal Control Guidelines*  
"Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission" issued by the SFC.
- h. *Licensed corporation*  
A corporation which is granted a licence by the SFC under Part V of the SFO for a regulated activity.
- i. *Liquid assets*  
Such assets as are prescribed in Division 3 of Part 4 of the FRR.
- j. *Liquid capital*  
The amount by which liquid assets exceeds ranking liabilities.
- k. *Ranking liabilities*  
The amounts required under Division 4 of Part 4 of the FRR.
- l. *Registered institution*  
An authorized financial institution registered under Part V of the SFO.
- m. *Regulated activities*  
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. *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.

p. *SFC*

Securities and Futures Commission.

q. *SFO*

Securities and Futures Ordinance.

r. *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.

s. *Systems of control*

The internal controls over trading, accounting, settlement and stock holding systems that a licensed corporation or an associated entity has implemented to ensure its compliance with the SFO and any rules made under the SFO.

## **Legislation and regulatory requirements**

### **The SFO**

9. Under the licensing and registration regime of the SFO, any business entity which carries on or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by or registered with the SFC. It is a serious offence to act as an intermediary in Hong Kong without the appropriate licence or registration.
10. The SFC administers the regulation of the regulated activities and assumes the duties of front-line regulator of licensed corporations. It also applies certain requirements to associated entities of intermediaries in relation to their receipt and holding of client assets. The SFC is also responsible for all investigations and disciplinary matters under the SFO, subsidiary legislation, codes and guidelines.
11. Regulated entities must observe at all times all the provisions of the SFO, subsidiary legislation, codes and guidelines. In association with these requirements, regulated entities must file audited annual financial statements within four months of the financial year end to the SFC.
12. The SFO is designed to protect investors and, therefore, is concerned with ensuring that regulated activities in Hong Kong are conducted in accordance with the relevant regulations and rules by persons who are fit and proper and are licensed or registered to conduct such business.
13. The regulatory powers of the SFC are primarily vested in the SFO.
14. Section 5 of the SFO details the functions of the SFC. The functions pertinent to this Practice Note are as follows:
  - a. to take steps to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - b. to supervise, monitor and regulate activities carried on by regulated entities;

- c. to promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on regulated activities;
- d. to promote and develop an appropriate degree of self-regulation;
- e. to take steps it considers appropriate to ensure relevant provisions are complied with;
- f. to secure an appropriate degree of protection for members of the investing public investing in or holding financial products;
- g. to promote, encourage and enforce the adoption of appropriate internal controls and risk management systems; and
- h. to suppress illegal, dishonourable and improper practices in the industry.

*Regulated activities*

15. The SFO covers nine types of regulated activities:

Type 1: dealing in securities;

Type 2: dealing in futures contracts;

Type 3: leveraged foreign exchange trading;

Type 4: advising on securities;

Type 5: advising on futures contracts;

Type 6: advising on corporate finance;

Type 7: providing automated trading services;

Type 8: securities margin financing; and

Type 9: asset management.

*Auditor's statutory rights and duties*

16. Guidance on the auditor's statutory rights and duties under the SFO is given in Parts III and V below.

**Regulatory requirements**

17. The SFO provides a framework for the regulation of regulated entities in Hong Kong and the detailed requirements are set out in subsidiary legislation, codes or guidelines issued by the SFC. Each regulated entity is bound by all these requirements, where applicable, to remain fit and proper. The main provisions of the SFO, subsidiary legislation, codes or guidelines are set out in the following paragraphs but they are not a substitute for the legislation and rules themselves. In addition, the SFC has posted a series of "Frequently Asked Questions" on its website which provide a useful source of reference on how to interpret specific circumstances which may arise.

*Licensing and registration*

18. Persons carrying on business in a regulated activity in Hong Kong are required to have successfully applied for a licence, or a registration in the case of an authorized financial institution. In addition, they must remain fit and proper at all times.

*Business conduct*

19. This is the ongoing requirement expected of regulated entities in conducting their business and is designed to ensure that adequate standards are maintained in dealings with clients.

20. The requirements for business conduct are set out either in subsidiary legislation or in non-statutory codes of conduct. Breach of legislation is subject to criminal sanctions and breach of any codes of conduct may be taken into account in determining fitness and properness. The auditor has no requirement to express an opinion on the business conduct of a regulated entity but should be aware of the requirements.
21. The nine basic principles for business conduct cover the following areas:
- a. honesty and fairness;
  - b. diligence;
  - c. capabilities;
  - d. information about clients;
  - e. information for clients;
  - f. conflicts of interests;
  - g. compliance;
  - h. client assets; and
  - i. responsibility of senior management.

*Client assets*

22. The client asset rules apply to regulated entities that control or are otherwise responsible for client assets and they cover the proper protection of these assets. There are two sets of rules:
- a. one dealing with client securities; and
  - b. the other dealing with client money (not applicable to an associated entity of a registered institution or an associated entity of a licensed corporation where the associated entity is an authorized financial institution).
23. The Securities and Futures (Client Securities) Rules require client securities and securities collateral received or held in Hong Kong to be treated by regulated entities in a prescribed manner, such as depositing the securities in the safe custody of a segregated account. There are no prescribed rules for client securities received or held overseas.
24. The Securities and Futures (Client Money) Rules require segregation of client money received or held in Hong Kong by licensed corporations and their associated entities (unless they are authorized financial institutions) within the specified time limit. There are no prescribed rules for client money received or held overseas.

*Record keeping*

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

*Financial resources requirements*

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

## PART II - THE AUDIT OF FINANCIAL STATEMENTS

### Introduction

28. Hong Kong Standards on Auditing (HKSA) apply to the audit of the financial statements of any entity, irrespective of the size of the entity, its legal form, or the nature of its activities. The commentary which follows identifies the special considerations arising from the application of certain individual HKSA to the audit of the financial statements of regulated entities, and suggests ways in which these can be addressed. Where no special considerations arise in relation to a particular HKSA, no material is included. For the specific requirements of a HKSA, auditor would refer to the HKSA concerned.

### HKSA 210: TERMS OF AUDIT ENGAGEMENTS

#### Background note

*The auditor and the client should agree on the terms of the engagement. (HKSA 210 paragraph 2)*

29. In addition to those principal contents set out in HKSA 210, the auditor's engagement letter would also cover reporting requirements under the Securities and Futures (Accounts and Audit) Rules and in particular, the auditor's rights and duties to report directly to the SFC. The engagement letter makes it clear that the statutory duty to report places an obligation on the auditor to report matters if found and does not involve undertaking additional work to identify them. It also clarifies that the auditor may sometimes consider it necessary to report directly to the SFC without the client's prior knowledge or consent.

### HKSA 240: THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

#### Background note

*In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud. (HKSA 240 paragraph 3)*

30. In addition to the conditions or events specified in HKSA 240 as increasing the risk of fraud, the following factors may be especially relevant for regulated entities (this list is not exhaustive):
- a. backlogs in key reconciliations, particularly those with brokers and exchanges and for bank accounts and safe custody accounts - both the regulated entity's own and those relating to its clients;
  - b. inadequate segregation of duties between the front, middle and back office staff (i.e. "incompatible functions");
  - c. complex products and transactions inadequately understood by management;
  - d. inadequate definition of management responsibilities and supervision of staff;
  - e. elements of the remuneration package (particularly bonuses) for certain staff which are highly geared in relation to reported profits or revenues;
  - f. existence of hold mail arrangements, operation of discretionary accounts, and issuance and acceptance of third party or cash cheques;
  - g. volatility in the market place;



- h. no established compliance culture or inadequate internal controls; and
- i. risk of management override of controls.

Additional factors relevant for regulated entities can be found in the SFC's website which contain press releases and circulars providing examples of malpractices and advisory circulars of compliance areas.

- 31. Regulated entities are specifically required by the SFC to have adequate systems of internal control over client assets, which include appropriate systems to minimize the risk of losses to the business from irregularities, fraud or error. The auditor needs to bear in mind their responsibilities to report to the SFC in accordance with guidance set out in Part V below.

## **HKSA 250: CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

### **Background note**

*When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. (HKSA 250 paragraph 2)*

- 32. The auditor needs to recognize particularly that some laws and regulations are central to the regulated entity's ability to conduct its business as compliance is a prerequisite of obtaining a licence to operate. Non-compliance may reasonably be expected to result in the regulated entity ceasing operations, or call into question the regulated entity's status as a going concern.
- 33. The auditor of regulated entities will normally:
  - a. discuss with the regulated entity's general counsel, compliance officer, internal auditor and other personnel responsible for compliance, and review any work on compliance matters carried out by them;
  - b. read the SFC's press releases and public register of licensed persons on its website for any disciplinary actions or licensing conditions imposed on the licensed corporation, its responsible officer or licensed representative;
  - c. review correspondence between the regulated entity and the SFC; and
  - d. assess the actual or contingent consequences arising from non-compliance and consider the impact on the financial statements.

### **Money Laundering**

- 34. 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.

35. 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 notes and circulars issued by the SFC. The HKICPA has issued in July 2006 a Legal Bulletin on "Requirements on Anti-money Laundering, Anti-terrorist Financing and Related matters".
36. The SFC expects regulated entities to establish policies and controls to combat money laundering and terrorist financing which cover the following areas:
  - a. the establishment and maintenance of policies, procedures and controls to deter and to recognize suspicious transactions;
  - b. the establishment of a procedure to report suspicious transactions;
  - c. evidence of client identification;
  - d. retention of client identification and transaction records for use as evidence in future investigations; and
  - e. education and training of staff.

**Codes and guidelines issued by the SFC**

37. The auditor has no direct reporting responsibility in respect of the codes and guidelines issued by the SFC. Nevertheless, breaches of such codes and guidelines may:
  - a. give rise to claims by investors against the regulated entity; and
  - b. cause the regulated entity to have its business restricted or, in extreme cases, have its licence revoked so threatening its viability as a going concern.
38. The auditor will also be aware that breaches of the codes and guidelines could have consequences for other matters which are the subject of the auditor's reporting responsibilities to the SFC for example, financial resources, accounting records and the handling of client assets.
39. The auditor would ensure that members of the audit team have a general understanding of the applicable codes and guidelines, sufficient to enable them to be alert to possible non-compliances which come to their attention.
40. As part of the normal procedures undertaken for the purposes of the audit of the financial statements and reporting under the Securities and Futures (Accounts and Audit) Rules, the auditor would gain an understanding of the regulated entity's operations, including the nature of the business carried out. They would also obtain an understanding of the control environment that exists, including the regulated entity's higher level procedures for complying with the applicable codes and guidelines.
41. 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.
42. The auditor needs to be alert to any indication that a regulated entity is conducting business outside the scope of its licence as this may amount to an offence under the SFO.
43. Where an apparent non-compliance of the codes and guidelines comes to the auditor's attention, it needs to ensure that the implications for its reporting responsibilities are correctly identified.
44. The auditor would enquire of management and staff whether any non-compliances have occurred and obtain appropriate representations from management, preferably in writing, addressing any possible non-compliances which have come to their attention.
45. The auditor would also note that the Codes and Guidelines issued by the SFC are not exhaustive in nature and auditor would always exercise professional judgment in determining the adequacy of controls and certain behaviours/conduct.

## **HKSA 260: COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE**

### **Background note**

*The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. (HKSA 260 paragraph 2)*

46. The SFC may request copies of the auditor's management letters from regulated entities. Against this background, the auditor may consider it prudent to include in its report 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 auditor; and
  - c. no responsibility is assumed by the auditor to any other person.

### **Breach of laws and rules issued by the SFC**

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

## **HKSA 300: PLANNING AN AUDIT OF FINANCIAL STATEMENTS HKSA 315: UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**

### **Background note**

*The auditor should plan the audit so that the engagement will be performed in an effective manner. (HKSA 300 paragraph 2)*

*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. (HKSA 315 paragraph 2)*

49. Regulated entities can be complex and the auditor would seek to understand the business and the regulatory regime in which they operate. The auditor would ensure that the audit engagement is performed/overseen by staff with sufficient knowledge about the licensed corporation's operations, market practices, the products handled by the licensed corporation and the SFC regulations for regulated activities carried out by the licensed corporation. A fundamental principle embodied in the HKICPA Code of Ethics for Professional Accountants is that the auditor does not accept or perform work which it is not competent to undertake. The auditor may also consider the use of technical specialists, for example where the business is trading in complex products or is heavily reliant on e-commerce. Generally, there is a close relationship between planning and understanding the entity and an understanding of the high level control environment.
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. The auditor plans so as to ensure that its audit work on the financial statements and the regulatory reporting is completed within timescales imposed by the SFC. The audit plan for a regulated entity typically explains the legal and regulatory background and, in order to reduce audit risk, discusses those areas where the auditor's responsibilities are different from those for other types of entity.

### **Direct communication from the SFC**

51. As explained in paragraph 162 below, the SFC is able to disclose information directly to the auditor. Where such a matter has been brought to the attention of the auditor, it considers the implications for its work and may amend its approach accordingly. However, the fact that it may have been informed of such a matter by the SFC does not, of itself, require the auditor to change the scope of its work, nor does it require the auditor actively to search for evidence in relation to the matter communicated by the SFC.
52. The auditor has no obligation to seek out breaches of the law, codes and guidelines. However, the auditor would include procedures within their planning process to ensure that members of the audit team are able to recognize reportable matters which are likely to be encountered in their audit work and that such matters are reported to the audit partner without delay.

### **Internal controls and risk assessment**

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. The auditor assesses the adequacy of controls in relation to the circumstances of each entity. In addition to the factors set out in appendices 1 and 2 of HKSA 315, the following factors would be considered by the auditor in assessing whether there may be an increased level of inherent risk of material misstatement:

- a. the nature and status of the regulated entities and any changes in their status which may affect the application of protection of clients' assets requirements;
  - b. a change in the market environment (for example, high volatility);
  - c. the introduction of new clients or products or marketing and distribution methods (for example e-commerce);
  - d. claims made in promotional literature (for example in relation to risks and performance);
  - e. the risk profile of business undertaken;
  - f. client profile (retail vs. institutional);
  - g. existence of claims and complaints by clients;
  - h. the complexity of products;
  - i. the consistency of products, methods and operations in different departments or locations;
  - j. the legal and operational structure of the regulated entities;
  - k. where a group structure exists, the financial and managerial support provided to and by other group companies;
  - l. the number of branches or sales offices (see paragraph 56 below);
  - m. the use of licensed representatives;
  - n. management's attitude towards regulation, compliance and control and its appreciation of the importance of investor protection;
  - o. the respective roles and responsibilities attributed to the finance, internal audit and compliance functions;
  - p. the recruitment, competence, training and supervision of personnel; and
  - q. the integrity, competence and experience of management.
54. Regulated entities vary greatly in the complexity of their operations and hence in the reliance which the auditor places 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. Notwithstanding its off-balance sheet nature, client assets are an important and relevant factor to audit planning and any material deficiency in the adequacy of internal controls over client assets will need to be reported in the Compliance Report (see paragraphs 106 to 109). Any shortfall in client assets, whether due to misappropriation or otherwise, may have significant implications on the licensed corporation's compliance with the client asset rules and the adequacy of its internal controls. Furthermore, such shortfall could also impact on the financial position of the licensed corporation. Such implications and impact could affect the opinions to be given by the auditor in its audit report and compliance report and trigger the auditor's obligation to report to the SFC under section 157 of the SFO. If the auditor considers that the licensed corporation's system of control over client assets are inadequate or decides that no reliance would be placed on the licensed corporation's systems, the auditor would use its

professional judgment to consider the use of fund tracing procedures as a substantive procedure to obtain evidence on some of the control objectives, e.g. paragraphs 45 and 47 of Appendix 2. Fund tracing means obtaining copies of sampled outward cheques issued by the licensed corporation from the bank and verifying the identity of the payee against the licensed corporation's accounting records.

56. Some regulated entities operate a network of branches. In such instances, the auditor determines the degree of head office control over the business and accounting functions at the branch office and the scope and effectiveness of the regulated entity's inspection and/or internal audit visits. Where branches maintain separate accounting records, the extent of audit visits and work on each branch is also dependent on the materiality of, and risks associated with, the operations of each branch and the extent to which controls over branches are exercised centrally. In the case of smaller branches, the degree to which exceptions to the regulated entity's normal control procedures may be caused by minimal staffing levels (the greater difficulty of ensuring adequate segregation of duties, for example) and the consequent need for an increased level of control from outside the branch are relevant to audit planning.
57. The auditor would consider how a computer information system (CIS) environment affects the audit. Computer information system (CIS) is integral to the business of a regulated entity due to the high volume of transactions and the linkages to various third party systems. Many regulated entities also use their CIS to prepare regulatory reports to the SFC. It is therefore common for the auditor to require a detailed knowledge of the regulated entity's CIS.
58. As new CIS technologies emerge, they are frequently employed by regulated entities to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of CIS and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

## **HKSA 320: AUDIT MATERIALITY**

### **Background note**

***The auditor should consider materiality and its relationship with audit risk when conducting an audit. (HKSA 320 paragraph 2)***

59. The assessment of materiality for the financial statements of a Licensed Corporation will require an auditor to make the same professional judgment decisions as on any audit with reference to the Standard. However the auditor would remember that in respect of the Compliance Report there is no materiality concept outlined in the Securities and Futures (Accounts and Audit) Rules and therefore if the auditor becomes aware of any breach in the relevant Rules then that breach needs to be reported in the Compliance Report. The Audit Questionnaire that the auditor is asked to complete for submission to the SFC does however refer to whether the auditor has found any material breaches between the FRR submitted and the financial statements and therefore it is possible to have a reconciliation reported in the Compliance Report in respect of immaterial discrepancies between the submitted FRR and the financial statements but not to report this matter in the Audit Questionnaire if it is deemed to be immaterial.

## HKSA 402: AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS

### Background note

***The auditor should consider how an entity's use of a service organization affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures. (HKSA 402 paragraph 2)***

60. Some regulated entities outsource a variety of activities. Specific examples include:
- a. safe custody of client assets by a custodian;
  - b. settlement or clearing of trades (this may or may not include the third party taking on the settlement risk, maintaining accounting records, reconciling client assets, sending client statements directly);
  - c. maintenance of accounting records;
  - d. product administration (such as unit trusts or savings schemes);
  - e. investment management; and
  - f. valuation of investments.
61. A regulated entity would ensure compliance with the law, codes and guidelines whether or not activities are outsourced. In addition, a regulated entity using a service organization would comply with the following requirements in respect of the outsourced activities:
- a. ongoing assessment and monitoring of the competence and independence of the third party including reviewing of reports issued in accordance with Practice Note 860.2 "Reports on internal controls of investment custodians made available to third parties" or other relevant service provider reports;
  - b. responsibility for keeping records; and
  - c. responsibility for acts or omissions by the third party.

## HKSA 505: EXTERNAL CONFIRMATIONS

### Background note

***The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level. (HKSA 505 paragraph 2)***

62. 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.
63. For efficiency purpose, the auditor may circularize external confirmations of client account balances together with client assets held for custody so as to obtain audit evidence to support the financial statement assertions and regulatory reporting items at the same time. Further details on circularisation are set out in paragraph 27 of Appendix 2 to this Practice Note.

64. In determining the auditor's assessment of risk, consideration as to whether or not to perform external circularisation would also be linked to the fraud assessment (HKSA 240) and the assessment of the quality of internal controls, particularly over client assets (HKSA 315). The higher the auditor's assessment of risk, the more important it is for the auditor to seek reliable and relevant audit evidence from substantive procedures. For example, if the auditor considers that the licensed corporation has inadequate systems of control over client assets, or the auditor decides not to rely on the licensed corporation's internal control systems, then external confirmations of client account balances and client assets held by the licensed corporation would be a strong substantive audit procedure. In addition, the auditor may find it effective to supplement such external confirmations with a questionnaire to obtain corroborative information on the licensed corporation's compliance with aspects of the legislation and rules that the auditor also has responsibility to verify e.g. standing authorities.

## **HKSA 560 (REVISED): SUBSEQUENT EVENTS**

### **Background note**

*The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. (HKSA 560 (Revised) paragraph 2)*

65. In addition to the specific procedures to identify subsequent events which may require amendment to, or disclosure in the financial statements outlined in paragraph 6 of HKSA 560 (Revised), for the regulated entity, the auditor 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.

## **HKSA 570: GOING CONCERN**

### **Background note**

*When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. (HKSA 570 paragraph 2)*

66. In reviewing going concern, the auditor of a regulated entity would consider the following areas in addition to those set out in paragraph 8 of HKSA 570, since the possible regulatory action of the SFC on the regulated entity is particularly relevant to the going concern assumption:
- a. regulatory censure or fines;
  - b. regulatory capital shortages;
  - c. visits from the SFC;
  - d. reputation and other indicators (including client complaints);
  - e. general non-compliance with the law, codes and guidelines; and
  - f. unusual movements in the financial market.
67. If the auditor has any doubts as to the ability of a regulated entity to continue as a going concern, it may be required to make a report to the SFC under their statutory duties on which guidance is set out in Part V below.



## HKSA 580: MANAGEMENT REPRESENTATIONS

### Background note

*The auditor should obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements. (HKSA 580 paragraph 3)*

68. In addition to the examples of representations given in HKAS 580, the auditor of a regulated entity would also consider obtaining additional confirmations. The letter could cover inter alia the following representations:
- a. acknowledging management's responsibility for establishing and maintaining accounting records and systems of control in accordance with the law, codes and guidelines;
  - b. confirming that management has made available to the auditor all correspondence and notes of meetings with the SFC during and related to the relevant reporting period and up to the date of the auditor's report;
  - c. that all complaints have been drawn to the attention of the auditor;
  - d. where applicable, representation that no client money or client securities were administered or held by the regulated entity; and
  - e. that the requirements under the Securities and Futures (Keeping of Records) Rules, the client asset rules and the FRR have been complied with.

## HKSA 720: OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

### Background note

*The auditor should read the other information to identify any material inconsistencies with the audited financial statements. (HKSA 720 paragraph 2)*

69. The SFC has issued an Account Disclosure Document for Licensed Corporation setting out additional financial information to be disclosed. The auditor would comply with the requirements in HKSA 720 in respect of the additional financial information which would be disclosed as part of the accompanying information to the financial statements. The auditor is 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.

## **PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES**

### **Introduction**

70. This Part of the Practice Note is intended to provide a common approach to reporting by the auditor on regulated entities and to establish clear unequivocal wording of the auditor's reports such that a standard form of wording may be used by the auditor when reporting. One benefit of establishing a standard form of report is that it removes any ambiguity as to the assurance obtained from the auditor about compliance with the requirements of the SFO. Example auditor's reports are set out in Appendix 1 to this Practice Note.

### **Management's responsibilities**

71. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules addresses matters for which the primary responsibility lies with the management of the regulated entity. The primary responsibilities of management under the Securities and Futures (Accounts and Audit) Rules are, broadly:
- a. to prepare annual financial statements in accordance with generally accepted accounting principles;
  - b. to prepare the applicable returns as detailed in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules;
  - c. to prepare an Account Disclosure Document which sets out additional financial information (for Licensed Corporations only);
  - d. to prepare Analysis of Client Assets (for Associated Entity only);
  - e. to ensure that the client asset rules and the Securities and Futures (Keeping of Records) Rules are observed; and
  - f. to prepare the Business and Risk Management Questionnaire.

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

72. Management should consider the above in their design and maintenance of the systems of control. They should also recognize where appropriate the cost of a particular control, as against its purpose and expected benefit.
73. 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.
74. In designing a control system, management needs to understand the interaction between manual and computer controls and how they contribute in aggregate to the achievement of the control objectives.

### **Auditor's responsibilities**

75. The auditor's reporting responsibility under the Securities and Futures (Accounts and Audit) Rules is primarily to provide assurance to the SFC on the financial information provided by the regulated entity and on the systems of control operated by the regulated entity during the financial year covered by the report in relation to the regulated entity's stewardship of client assets.
76. The precise matters on which the auditor is required to report vary according to the nature of the regulated entity's activities. Under section 4(1) of the Securities and Futures (Accounts and Audit) Rules, the auditor is required to report on the matters covered in paragraphs 77 and 78 below. The auditor will prepare an audit report on the regulated entity's financial statements and a compliance report, which is addressed to the board of directors of the regulated entity.
77. In the auditor's report on financial statements, the auditor should give an opinion:
- a. whether the financial statements give a true and fair view; and
  - b. whether the financial statements are in accordance with the records kept by the regulated entity under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules.
78. In the auditor's Compliance Report to management, the auditor should cover:
- a. in the case of a licensed corporation, whether the required returns made up to the last day of the financial year as detailed in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules have been correctly compiled from the records of the licensed corporation or, if not correctly compiled, the nature and extent of the incorrectness;
  - b. in so far as applicable, whether the regulated entity had systems of control in place that were adequate to ensure compliance with the SFC's requirements with regard to client assets during the financial year in question;
  - c. in so far as applicable, whether the regulated entity complied with the Securities and Futures (Keeping of Records) Rules and the client asset rules during the financial year in question; and
  - d. in the case of a licensed corporation, whether there appears to have been any contravention of the FRR by the licensed corporation during the financial year in question.

## **General guidance for fulfilling auditor's responsibilities**

79. In discharging its reporting responsibilities regarding a regulated entity, the auditor must have particular regard to any changes in the SFO and its subsidiary legislation and any other requirements of the SFC in force during the financial year to which the report relates.
80. The nature of the business undertaken by a regulated entity, its size and its particular circumstances will affect the nature and extent of the auditor's work. When planning its work, the auditor assesses the risks associated with the nature of the particular regulated entity. Certain risks will not be applicable to all regulated entities.
81. Other factors that will be considered are:
- a. the scope of licensing in relation to the holding of client assets;
  - b. the extent of investment management discretion permitted;
  - c. the introduction of new and revised requirements, with reference to the up-to-date Q and A sections on the SFC website;
  - d. changes to existing requirements; and
  - e. modifications or waivers granted or special conditions imposed by the SFC.
82. In making an assessment of various risk factors, the auditor would normally meet senior management and the Compliance Officer as part of its planning process. It would also consider the following:
- a. operational manuals;
  - b. documentation of systems and controls;
  - c. compliance monitoring programmes and results;
  - d. the records maintained by the regulated entity of any non-compliances and notifications to the SFC that may have occurred during the 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;
  - h. any relevant internal audit reports; and
  - i. any unresolved items from previously issued management letters on internal control weakness.

## **Auditor's reporting requirements**

83. The two separate reports mentioned in paragraph 76 above are required to be prepared by the auditor in respect of the year under review. They are required to be submitted by the regulated entities to the SFC within four months of their year end. The auditor should take all reasonable steps for its reports to be issued in order for the regulated entities to submit them to the SFC by the specified date.

### **The auditor's report on the financial statements**

84. For a regulated entity which is a Hong Kong incorporated company, the auditor's report contains an audit opinion expressed in true and fair terms pursuant to the Companies

Ordinance requirements. It also states whether the financial statements are in accordance with the records kept under the Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Securities and Futures (Accounts and Audit) Rules. An example auditor's report is given in Example 1 of Appendix 1 to this Practice Note.

85. Guidance on the detailed requirements of the Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules, which are also applicable to the auditor's report are set out in paragraphs 89 to 100 below.

#### **Compliance Report by the auditor**

86. The Compliance Report setting out the auditor's conclusions on matters set out in paragraph 78 should be addressed to the directors of the regulated entity:
- a. For a licensed corporation, an example Compliance Report is given in Example 2 of Appendix 1 to this Practice Note.
  - b. For an associated entity of an intermediary, an example Compliance Report is given in Example 3 of Appendix 1 to this Practice Note.

#### *The assurance standards followed*

87. The auditor would state that it has conducted its Compliance Reporting engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 *Assurance Engagements Other Audits or Reviews of Historical Financial Information* issued by the HKICPA, and with reference to this Practice Note. It also states that it has carried out such procedures as were considered necessary for its report.

#### *The date of the report*

88. It is highly desirable that the Compliance Report is dated with the same date as the auditor's report on the financial statements.

### **Guidance on the reporting requirements of the Compliance report**

#### ***Internal control considerations relating to Securities and Futures (Keeping of Records) Rules and Securities and Futures (Accounts and Audit) Rules***

89. In considering the adequacy of systems of control required by the client asset rules and the Securities and Futures (Keeping of Records) Rules, the auditor must recognize the inherent limitations of such systems. These limitations mean that, despite the existence of controls, errors or irregularities may occur and may not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or the risk that the degree of compliance with those procedures may deteriorate.
90. The auditor is required to report whether the regulated entity has satisfied the requirements of the Securities and Futures (Keeping of Records) Rules during the period under review. In order to report on whether the regulated entity has satisfied the requirements of these rules it is envisaged that consideration will be given to whether adequate systems for control of the regulated entity's accounting systems have been maintained.
91. 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 auditor, in forming a view as to whether adequate records have been kept, will need to refer to the detailed rules relevant to the particular regulated activities.

92. The Securities and Futures (Keeping of Records) Rules require that regulated entities shall in relation to the businesses which constitute any regulated activities for which they are licensed and their associated entities as regards the receipt or holding of client assets in relation to such regulated activities, to keep, where applicable, such accounting, trading and other records as are sufficient to:

*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 readily to establish whether it has complied with the FRR; and
- h. keep records specified in the Schedule to and sections 5, 6, 7(2) or 8 of the Securities and Futures (Keeping of Records) Rules.

*an associated entity*

- a. account for the client assets;
  - b. enable all movements of the client assets to be traced through its accounting systems and, where applicable, stock holding systems;
  - c. show separately and account for all receipts, payments, deliveries and other uses or applications of the client assets effected by it, or on its behalf, and on whose behalf such receipts, payments, deliveries or other uses or applications of the client assets have been effected;
  - d. reconcile, on a monthly basis, any differences in its balances or positions with other persons and show how such differences were resolved;
  - e. demonstrate compliance with certain sections of the client asset rules and that it has systems of control in place to ensure such compliance; and
  - f. keep certain specific records where applicable.
93. These records would be kept in such a manner as will enable an audit to be conveniently and properly carried out, and make entries in these records in accordance with generally accepted accounting principles where applicable. There are also particular requirements, over and above those outlined above, for licensed corporations involved in certain regulated activities.
94. Detailed guidance on the control objectives and audit evidence in relation to the auditor's reporting requirements with regard to client assets under the Securities and Futures (Accounts and Audit) Rules are included in Appendix 2 to this Practice Note. The auditor will need to apply judgment in determining the extent and nature of its work which would be based on a good understanding of the regulated entity's systems of control.

95. 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.
96. 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.
97. 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.
98. 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.
99. Systems of control, including the assignment of responsibilities as set out in the Internal Control Guidelines, need to be clearly documented if they are to be understood, communicated and operated effectively and consistently. Regulated entities and their auditor would consider whether appropriate documentation is a prerequisite of an adequate system.
100. The effective operation of a control system may be enhanced by an internal audit department or by specific monitoring performed by a compliance department. The existence of such departments and their scope and objectives are matters for management. In assessing the effectiveness of such departments, the auditor will consider the terms of reference of the departments, their independence from operational personnel and management, the quality of staffing and to whom they report in the regulated entity.

***Securities and Futures (Financial Resources) Rules***

101. Licensed corporations are required to submit to the SFC the following financial returns as referred to in section 3(1)(b) of the Securities and Futures (Accounts and Audit) Rules made up to the last day of the financial year:
  - a. liquid capital computation (Form 1);
  - b. required liquid capital computation (Form 2);
  - c. summary of bank loans, advances and other credit facilities (Form 3);
  - d. Analysis of margin clients (Form 4);
  - e. Analysis of collateral received from margin clients (Form 5);

- f. Analysis of rolling balance cash clients (Form 6);
- g. Analysis of client assets (Form 8); and
- h. Analysis of proprietary derivative positions (Form 10).

There is a requirement in the Compliance Report to state that the auditor is not aware of the licensed corporation not complying with the FRR throughout the year. If the licensed corporation has a very low excess liquid capital or is prone to material errors this may lead to the auditor deciding to review and test a larger sample of FRR throughout the year.

- 102. The auditor is required to give an opinion as to whether the financial returns referred to in paragraph 101 which have been submitted to the SFC have been correctly compiled from the records of the licensed corporation, or if not correctly compiled, the nature and extent of the incorrectness. This involves the auditor in examining the licensed corporation's compilations by reference to the FRR, paying particular attention to those areas most susceptible to management's discretion and having regard to the concept of prudence. Particular care will be exercised in cases where the licensed corporation is operating at a level close to the minimum requirement, since any shortfall (however small) is a contravention of the FRR and results in a higher possibility of window dressing. The auditor would note that the Securities and Futures (Accounts and Audit) Rules do not provide that immaterial discrepancies or reclassifications can be disregarded. Accordingly, the auditor qualifies its opinion where discrepancies and reclassifications are identified in the financial returns regardless of materiality.
- 103. If the auditor qualifies its Compliance Report in respect of the financial returns, the auditor either provides the reconciliations or explains the differences. The reconciliations or explained differences are attached to the Compliance Report.
- 104. In particular the auditor would check that the reconciliation agrees back to supporting documentation and that the explanations given for any reconciling items are reasonable. Reconciling items commonly relate to audit adjustments made after submission of the financial return.
- 105. It is common for a licensed corporation to submit a revised FRR return if errors are noted following the original submission in order to avoid a qualified Compliance Report attaching a reconciliation. An auditor should ensure that he/it identifies clearly the FRR he/it is commenting on in his/its Compliance Report and this should be the latest FRR submitted to the SFC prior to the date of the Compliance Report.

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

- 106. There are essentially two aspects to the auditor's 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 Practice Note. The auditor applies judgment in determining the extent and nature of its work which is based on the following general requirements:
  - a. the auditor understands the business of the regulated entity and the environment in which the regulated entity operates;
  - b. the auditor reviews the regulated entity's systems and consider whether these are adequate for control and accounting purposes, and are in accordance with the requirements set out in the Suggested Control Techniques; and



- c. the auditor tests those systems and controls to establish that they are operating effectively.
108. When planning and carrying out its work, the auditor must always keep in mind the need for audit evidence in relation to the existence of client assets and the accuracy of the regulated entity's records.
109. Certain licensed corporations do not receive or hold client money or client securities either by choice or by limitation of their licensing condition. It would therefore not normally be necessary for the auditor to make reference to the client asset rules in the Compliance Report. However, the auditor would ensure that such licensed corporations have procedures in place to avoid receipt or holding of client assets. If during the course of the performance of these procedures (as set out in paragraphs 68 - 70 of Appendix 2 to this Practice Note) it comes to the auditor's attention that the licensed corporation has held client assets, it would be necessary for the auditor to make reference to the licensed corporation's compliance with the client asset rules in the Compliance Report. In these circumstances, the auditor will need to revisit the requirements under HKSA 250 and paragraphs 40 and 41 of this Practice Note.

***Qualified Compliance reports***

110. The auditor may qualify its Compliance Report on grounds other than those which arise in reporting on whether the financial statements give a true and fair view. Where the requirements of the rules upon which the auditor must report have not been met, its report includes a statement specifying the relevant requirements and the respect in which they have not been met, in sufficient detail for the breach or shortcoming to be clearly understood and evaluated. In particular, where the breach relates to a specific rule, the rule number or reference will be stated in the report.
111. In considering any matter indicating a possible breach of the FRR, client asset rules and the Securities and Futures (Keeping of Records) Rules or inadequate systems of control over client assets, the auditor analyzes the circumstances in order to identify its cause, and establish the action management has taken or intends to take to correct the matter.
112. If the auditor proposes to include any qualification or adverse statement in the Compliance Report (or its report on the financial statements), it is required under section 157(1)(b) of the SFO, as soon as reasonably practicable after it first proposes the inclusion of the qualification or adverse statement, to lodge with the SFC a report. Details are set out in Part V below.
113. The Securities and Futures (Accounts and Audit) Rules do not provide that trivial breaches can be disregarded. Where small exceptions are discovered, the auditor will need to qualify its opinion, although references can be made to the extent of the breach.

## **PART IV - OTHER REPORTING CONSIDERATIONS**

### **Audit Questionnaire**

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

### **Account Disclosure Document**

117. The SFC has issued the Account Disclosure Document for Licensed Corporation which sets out additional financial information to be disclosed by licensed corporations. In the Audit Questionnaire the auditor is requested by the SFC to state whether the auditor is satisfied that no material inconsistency between the audited financial statements and the additional disclosure of financial information as required by the Account Disclosure Document for Licensed Corporation came to its attention. The auditor would perform procedures on the additional financial information in accordance with HKSA 720 "Other Information in Documents containing Audited Financial Statements". If the auditor is aware of any material inconsistencies, the auditor states details of such inconsistencies in the Audit Questionnaire.

## **PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION**

### **Introduction**

118. This Part of the Practice Note is concerned with communications:

- a. by the auditor to the SFC under the obligations established in section 157 of the SFO;
- b. by the auditor to the SFC under the protection of section 158 of the SFO; and
- c. by the SFC to the auditor under section 378(3)(h) of the SFO.

It is also concerned with the related issue of auditor's duty of secrecy under the SFO.

119. Because of the variety of conditions which might be encountered, the guidance in this Part of the Practice Note is necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with its lawyers when it encounters such circumstances.

120. Under the SFO the auditor has various statutory responsibilities to report to the SFC. The auditor is automatically protected in making a report in discharge of such a statutory responsibility. Certain provisions of the SFO also provide the auditor with immunity from any liability it might otherwise incur by reason of the auditor making other reports to the SFC which it may consider to be relevant to the functions of the SFC. These responsibilities and avenues available for reporting do not require the auditor to change the scope of its audit work, nor the frequency or timing of its visits.

121. When the circumstances where reporting may be appropriate are being considered, it should be noted that investments in financial markets carry inherent risks. It is not the purpose of the SFO, nor the duty of the auditor, to protect the investors from the normal risks relating to such investment activities.

122. The auditor needs to bear in mind that its decision may have to stand up to examination at a future date on the basis of the following considerations:

- a. what it knew at the time;
- b. what it should have known in the course of its audit;
- c. what it should have concluded; and
- d. what it should have done.

The auditor should report to the SFC under section 157 of the SFO promptly and not postpone reporting the breaches until the issuance of the audit report or the compliance report. In addition, taking into account the factors raised above, the auditor should report under section 157 of the SFO in sufficient detail to enable the SFC to understand the nature and circumstances of the situation.

### **The auditor to lodge report with the SFC in certain cases**

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

123. The auditor has a statutory duty to lodge a report with the SFC in the following circumstances:

- a. if it decides to include in its audit report any qualification or adverse statement (SFO section 157(1)(b)). Such a written report is required to be lodged with the SFC as soon as reasonably practicable after the auditor first proposes the inclusion of the qualification or adverse statement; and

- b. if it resigns before the expiration of its term of office, intends not to seek re-appointment or otherwise cease to be the auditor (SFO section 157(2)). Such a notice in writing to notify the SFC is required within one business day of the event, outlining the reasons and any connected circumstances which the auditor considers should be brought to the attention of the SFC, or where there are no such circumstances state the fact.

**Section 157(1)(a) of the SFO**

124. Section 157(1)(a) of the SFO provides that the auditor shall lodge a written report with the SFC, as soon as reasonably practicable after it becomes aware of any "reportable matter". A reportable matter is defined in section 157(3) of the SFO as:
- a. any matter which in the auditor's opinion adversely affects the financial position of the regulated entity to a material extent; or
  - b. a failure of the regulated entity to comply with any rules made under section 148, 149 or 151 of the SFO or a failure of the licensed corporation to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it.
125. These are statutory obligations and this Part of the Practice Note provides the auditor with procedures to follow when such circumstances arise.
126. Section 157(3) of the SFO includes a failure by the regulated entity to comply with any "prescribed requirement" as a "reportable matter". In addition to the requirements under any of the rules made under sections 148, 149 and 151 of the SFO, it also refers to the requirements under any of the rules made under section 152 of the SFO (provision of contract notes, receipts, statements of account and notifications by intermediaries and their associated entities). It should be noted that the requirements under any of the rules made under section 152 of the SFO are not included as "matters reportable by the auditor under section 157 of the SFO" in section 5 of the Securities and Futures (Accounts and Audit) Rules and therefore the auditor is not required to report to the SFC if there is a failure of the regulated entity to comply with section 152 of the SFO.

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

127. The auditor would take the initiative and ensure that a written report on the reportable matter under section 157(1)(a) of the SFO is lodged with the SFC if the conditions specified in paragraph 124 above exist. A distinction must be drawn here between an auditor's duty as stated in paragraph 124(a) and paragraph 124(b) above. The duty under paragraph 124(b) is clear and unequivocal: if the auditor becomes aware of a contravention of the requirements which are specified, it is not given any latitude for exercising judgment. The auditor is obliged to make a report. The duty under paragraph 124(a) is different. The auditor is given the right to form an opinion based on applying criteria as to the materiality of an adverse effect on the regulated entity's financial position in deciding whether reporting would be appropriate.
128. The HKICPA has developed a criterion for use by the auditor in deciding to take the initiative in lodging a written report with the SFC under paragraph 124(a) above. The criterion is that the auditor would lodge a written report with the SFC when it considers it expedient to do so in order for the SFC to protect the interests of investors because there has been a material loss or there exists a significant risk of material loss.
129. This criterion can be more fully explained as follows:
- a. there must be a significant adverse occurrence or a change in the auditor's perception of an existing situation, that may include an adverse change in the circumstances of the business; and
  - b. the situation described in (a) above has given rise to or has indicated that a reasonable probability exists that it may give rise to:

- i. a material financial loss to the business which would result in a material deterioration of the licensed corporation's liquid capital position under the FRR; or
  - ii. loss of control over the assets or records.
- 130. Examples of the circumstances encountered in which the situation set out in paragraphs 128 and 129 may be met include:
  - a. the auditor discovers a failure by the regulated entity to comply with the provisions of the SFO which may have material consequences; or
  - b. there is evidence of imminent financial loss of serious proportions which might cast doubt on the continuing viability of the regulated entity.

*Reporting procedures under section 157(1)(a) of the SFO*

- 131. In circumstances where the auditor concludes that a written report under section 157(1)(a) of the SFO to the SFC is necessary, it would adopt the following procedures, bearing in mind that speed may be of the essence:
  - a. The auditor would discuss the matter with the regulated entity (unless the matter relates to suspected or actual instance of fraud and serious misconduct by the management itself) and explain the auditor's statutory duty to lodge a written report with the SFC under section 157(1)(a) of the SFO and that it might be advisable for the regulated entity to make a report direct to the SFC immediately.
  - b. The auditor would then immediately lodge a written report with the SFC. The auditor would follow this with a written notification along with a copy of its report to the directors or management to inform them.
- 132. The auditor would note that lodging a written report with the SFC alone may not discharge all its responsibilities. For example, the auditor would consider the implications of the matter giving rise to the report under section 157(1)(a) of the SFO for its opinion on the financial statements, and its conclusions in the Compliance Report.

## **Other communications by the auditor**

### **Statutory protection under section 158 of the SFO**

- 133. Section 158 (1) of the SFO provides that:

"... no duty which a person may be subject to as an auditor ... shall be regarded as contravened by reason of his communicating in good faith to the Commission ..., whether or not in response to a request made by the Commission ..., any information or opinion on a matter which (a) he becomes aware of in his capacity as such auditor (whether or not in the course of performing his functions as such auditor); and (b) is relevant to any function of the Commission ...".
- 134. Section 158 of the SFO only gives immunity for the auditor appointed under section 153 of the SFO. It does not cover appointments under section 159 or 160 of the SFO which give the power of appointment to the SFC. However it does extend the immunity to:
  - a. an auditor who has ceased to be the auditor but became aware of a matter before his appointment ceased (SFO section 158(2)(a));
  - b. an auditor appointed by a former regulated entity (SFO section 158(2)(b)); and
  - c. an auditor who has ceased to be the auditor of a former regulated entity before his appointment ceased (SFO section 158(2)(c)).

135. Section 158 of the SFO does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the SFC. They provide a mechanism whereby the auditor may make matters known to the SFC with statutory protection from its duty of confidentiality.
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 auditor is obliged to report (see paragraphs 123 to 132 above). In interpreting this guidance, the auditor would bear in mind the fundamental objectives of the SFO, which are to ensure that the SFC is able to fulfil its function of safeguarding the interests of investors. The auditor would have regard to any function of the SFC as summarized in section 5 of the SFO.
137. Confidentiality is an implied term of auditor's contract with its client, but in certain circumstances and under conditions specified in section 158 of the SFO it does not prevail, since the auditor of a regulated entity is entitled to communicate in good faith to the SFC information or opinion on a matter which it becomes aware of in its capacity as the auditor of the regulated entity and is relevant to any function of the SFC, without the duty of confidentiality owed to the client being regarded as having been contravened.
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 auditor is under a statutory duty to report under section 157 of the SFO. Considerable care needs to be taken in disclosing matters arising during any tripartite meeting with the SFC as the auditor's knowledge of these matters may have been obtained while assisting the SFC rather than in its capacity as the auditor (see paragraph 143 below).
140. Examples of circumstances in which the auditor may communicate any matter to the SFC under section 158 of the SFO include:
  - a. the auditor considers investors have incurred, or are at significant risk of incurring, a material loss as a result of the regulated entity carrying on business in a manner that is not fit and proper;
  - b. there is evidence of:
    - i. fraud, dishonesty or serious incompetence; or
    - ii. serious failure to observe rules for the conduct of the regulated entity;
  - c. it has come to the attention of the auditor that the procedures, records or systems fail significantly to comply with, or to demonstrate compliance with, conduct of business requirements to which the regulated entity is subject (except in respect of client assets which are covered in section 157 of the SFO); and
  - d. the position is such that because of a significant risk which is material to the collective interests of investors, the investors' interests would be better safeguarded if the SFC were aware of the position, even if only to organize protective action.
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 auditor to extend the scope of its work in order to discover matters and it will only be in exceptional circumstances such as those described in paragraphs 154 and 155 that it may choose to seek statutory protection.

142. Any protected communication can be made either on the auditor's initiative or in response to a request from the SFC for information. The auditor would cooperate with the SFC and respond to any requests from the SFC for information, provided it has no reason to doubt that the request is relevant to the SFC's functions. The auditor may communicate a matter to the SFC with the protection of section 158 of the SFO regardless of the source of that information, provided it became aware of the matter in its capacity as the auditor of the regulated entity and it does so in good faith.
143. Matters of which the auditor becomes aware "in its capacity as the auditor" may not be restricted to those matters identified during the course of the audit work by the auditor and members of the audit team. The auditor or members of the audit team may become aware of a matter which is relevant to the functions of the SFC during the course of its carrying out work for the regulated entity other than audit work or through private discussions on social or other occasions, in which case the information will be known to them as individuals. In circumstances which suggest that a matter would be reported to the SFC if knowledge of it had been obtained in the capacity as the auditor, it would be prudent to make enquiries in the course of the audit work in order to establish whether this is the case from information obtained in this capacity. In addition, a matter which is relevant to the functions of the SFC and which is identified during the course of work for the regulated entity by another partner (or member of staff) such as a management consultant or tax partner may be deemed to be known to the auditor (see also paragraph 144 below).
144. The auditor cannot be expected to be aware of all circumstances which, had it known of them, would have led them to exercise its right to communicate under section 158 of the SFO. This section does not require the auditor to change the scope of its audit or other work for the regulated entity, nor the frequency or timing of its visits. The auditor has no obligation to seek out grounds for making a report under section 158 of the SFO, the section does not place an obligation on the auditor to conduct its work in such a way that there is reasonable certainty that it will discover a matter upon which the SFC may need to act. It is only when the auditor does become aware in the ordinary course of this work of such a matter, or of circumstances which suggest the existence of such a matter, that it would consider using the protection of section 158 of the SFO.
145. The SFC recognizes that it would not be appropriate for the auditor to report information which it has obtained or matters which it has identified through its professional relationship with another client, even though the information obtained or the matters identified may relate to a regulated entity.
146. The auditor would need to realize that section 158 of the SFO will not provide protection where it could be held to have acted maliciously or in bad faith or if the information reported is outside the scope of the section. The SFO does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by their action in reporting to the SFC. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of its report are such as to secure the protection of section 158 of the SFO and that it only includes relevant material.
147. The auditor is protected, however, even if the information which it communicates subsequently falls short of proof, or the opinion which it communicates cannot be verified. The auditor who can demonstrate that it has acted reasonably and in good faith in informing the SFC of any information or opinion on a matter which it thinks has occurred would not be held in breach of duty to its client even if, after an investigation, it were found there was not a matter which needed to be reported. These are areas where the auditor may wish to consider taking legal advice before making a report.
148. Whilst no breach of statutory duty might arise, it should be appreciated that there is no protection given by the SFO if the auditor, after becoming aware of an occurrence, fails to report, promptly, or at all, to the SFC. Furthermore, the auditor would need to recognize that speed of reporting is likely to be important in order to enable the SFC to protect the interests of investors.

### **Tripartite meetings**

149. As part of the SFC's system of supervision of regulated entities, meetings involving the SFC, the regulated entity and its auditor may be called by either the SFC, or the regulated entity possibly at the auditor's suggestion.
150. In such meeting, the auditor would be expected to discuss with the SFC the affairs of the regulated entity including:
  - a. the presentation and content of the financial statements;
  - b. the scope, conduct and outcome of the annual audit;
  - c. the scope, conduct and outcome of any report under section 158 of the SFO;
  - d. any points raised in the management letter which relate to the SFO;
  - e. explanations for, the reason for and nature of a qualified auditor's report or of a change in a previously reported intention to qualify an auditor's report;
  - f. any step or course of action which may be necessary in the light of the reports, for example, the commissioning of a more detailed report in a particular area (under section 159 or 160 of the SFO); and
  - g. matters raised by the SFC or those which the regulated entity or the auditor have drawn to its attention since any previous meeting, including how such matters have been resolved to the satisfaction of the auditor or have been reflected or treated in the financial statements.

### **Reporting via the regulated entity**

151. Where the auditor becomes aware of a matter which, in its professional judgment, it considers is not required to be reported under section 157 of the SFO but ought to be reported to the SFC, it would consider the facts and, unless inappropriate in the circumstances (described in paragraph 154 below), discuss the matter with the management.
152. It is important for the auditor to act in a manner that will maintain its professional relationship with its client. Normally, therefore, the auditor would ask the regulated entity to draw matters about which it is concerned to the attention of the SFC.
153. Where the regulated entity will not itself inform the SFC of a matter, having been advised to do so by the auditor, or where it has not been done within the period of time specified, or where there is no adequate evidence that the client has properly reported the matter in question, the auditor would make such a report direct to the SFC.

### **Reporting direct to the SFC**

154. In exceptional circumstances, where the auditor doubts whether management is fit and proper person to carry on business as a regulated entity and it would be in the interest of protecting investors that the management of the regulated entity would not be informed in advance, the auditor would report direct to the SFC after first considering the appropriateness of taking independent legal advice. Examples of these circumstances include:
  - a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where it believes that a fraud or other irregularity has been committed by the directors or senior management of the regulated entity, or it has evidence of the intention of directors or senior management to commit such a fraud or other irregularity; or



- b. where there has been an occurrence which causes the auditor no longer to have confidence that the directors or senior management will conduct the business of the regulated entity in a prudent manner so as to protect the interests of investors, e.g. where it has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the affairs of the business or its clients, or it has evidence of their inclination so to act.
155. The auditor would also report direct to the SFC when speed is of the essence. For example, when it becomes aware that the regulated entity may be about to cease being licensed, the auditor would consider the need to disclose to the SFC any information in its possession relevant to its functions without delay. The fact of such impending cessation of licence may bring forward the desirability of disclosing matters to the SFC, as it is easier for the SFC to take appropriate action while the entity is still licensed, particularly where such matters bear on the security of third party interests.

### **The auditor's duty of secrecy**

156. Section 378 of the SFO imposes a duty of secrecy upon any "specified person", within the meaning of that term in section 378(15). The auditor is bound by the duty of secrecy once it performs any function under or carries into effect any of the provisions of the SFO or assists another person in the performance of any function under or in carrying into effect any such provisions.
157. The precise scope of an auditor's statutory duty of secrecy is not definitive but is likely to include:
- a. any matter which, in the auditor's opinion, adversely affects the financial position of the regulated entity to a material extent and which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;
  - b. any evidence of the regulated entity's failure to comply with any rules made under section 148, 149 or 151 of the SFO, or any evidence of the licensed corporation's failure to comply with section 146 of the SFO or with any of the requirements of the FRR that apply to it, which is the subject of a written report by the auditor to the SFC (SFO section 157(1)(a)) and the contents of that written report;
  - c. the auditor's decision to resign before the expiration of its term of office, the auditor's decision not to seek re-appointment, or if the auditor otherwise ceases to be the auditor, and any reason for such decision which is communicated to the SFC under section 157(2) of the SFO;
  - d. any reason for including any qualification or adverse statement in the auditor's report on the regulated entity's financial statements (SFO section 157(1)(b)) which is communicated to the SFC to the extent that such reason is not self-evident from the contents of the report itself;
  - e. any communication by the auditor to the SFC under section 158 of the SFO, which is a communication of information or opinion on a matter which is relevant to any function of the SFC of which it becomes aware in its capacity as the auditor, whether or not it is at the time of such communication still the auditor of the regulated entity concerned; and
  - f. any communication by the SFC to the auditor under section 378(3)(h) of the SFO (see paragraphs 162 - 164 below).

158. Application of section 378 of the SFO would therefore prevent the auditor from communicating any matters such as those referred to in paragraph 157 above to any parties other than the SFC except under certain circumstances as discussed in paragraphs 159 and 160 below in relation to the matters mentioned in paragraph 157(c) above. It should be emphasised that application of section 378 of the SFO would also prevent the auditor from communicating information that is subject to the duty of secrecy to the regulated entity concerned except for information which the regulated entity already knows.
159. Section 210A(2) of the Companies Ordinance states that an auditor's notice of resignation shall not be effective unless it contains either (i) a statement to the effect that there are no circumstances connected with its resignation which it considers should be brought to the notice of the members or creditors of the company; or (ii) a statement of any such circumstances as aforesaid. Thus, the incoming auditor and members or creditors of a regulated entity may be informed by the outgoing auditor regarding its reasons to resign, not to seek re-appointment or otherwise cease to be the auditor. Disclosure of such information by the outgoing auditor of a regulated entity under the provisions of the Companies Ordinance is permitted under section 378(2)(e) of the SFO without breaching the duty of secrecy under section 378 of the SFO since the disclosure is made in accordance with a law.
160. In complying with a request by the incoming auditor to provide professional clearance which is required under HKICPA Code of Ethics for Professional Accountants, the outgoing auditor may communicate the matters referred to in paragraph 157(c) to the incoming auditor. The outgoing auditor is considered to be doing this for the purposes of carrying into effect the provisions of section 153 of the SFO in order that the incoming auditor can accept nomination as the auditor of the regulated entity under section 153 of the SFO.
161. Under this Practice Note, the auditor would prepare two auditor's reports separately in respect of reporting on the financial statements (see paragraph 84 above) and compliance reporting (see paragraph 86 above). Since the Compliance Report by the auditor is for filing with the SFC only and should not be made available to any other parties including the shareholders of the regulated entity, the auditor can disclose any contraventions by the regulated entity of the requirements referred to in paragraph 157(b) in the Compliance Report without breaching the duty of secrecy under section 378 of the SFO.

### **Communications by the SFC to the auditor under section 378(3)(h) of the SFO**

162. Section 378(3)(h) of the SFO empowers the SFC to disclose confidential information to the auditor of regulated entities for the purpose of enabling or assisting the SFC to perform its functions under the SFO without the consent of the person from whom it is received or to whom it relates. It should be noted that disclosure by the SFC of confidential information to the auditor is to the auditor only; it is not free to pass that information to others, such as its client regulated entity without the consent in writing of the SFC.
163. The SFC will generally take the initiative in bringing a matter to the attention of the auditor of a regulated entity under the provisions of section 378(3)(h) of the SFO if it considers disclosure is necessary to enable or assist the SFC to perform its functions under the SFO, and believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of its audit report or the way in which it carries out its reporting responsibilities. Where the SFC discloses confidential information to the auditor under section 378(3)(h) of the SFO, it will generally inform the auditor whether it has informed the regulated entity's management of the matter and, if so, whom.
164. If the auditor is not informed by the SFC of any such matter, it is entitled to assume that the SFC has no such disclosure to make. Accordingly, there is no need for the auditor to request the SFC to confirm this.

## APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS

### Example 1 - auditor's report on financial statements - regulated entity

#### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS 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 Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

#### *Auditor's responsibility*

Our responsibility is to express an opinion on these financial statements based on our 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 Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation 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.

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

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

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 Hong Kong Securities and Futures (Keeping of Records) Rules and Hong Kong Securities and Futures (Accounts and Audit) Rules of the Hong Kong Securities and Futures Ordinance**

In our opinion, the financial statements are in accordance with the records kept under the Hong Kong Securities and Futures (Keeping of Records) Rules and satisfy the requirements of the Hong Kong Securities and Futures (Accounts and Audit) Rules.

XYZ & Co.

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

[Address]

Date

## Example 2 - compliance report by the auditor - licensed corporation

### COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC SECURITIES LIMITED

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*] for submission by the company to the Hong Kong Securities and Futures Commission ("SFC").

#### Respective responsibilities of directors and auditor

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

- a. each of the returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] is correctly compiled from the records of the company;
- b.<sup>1</sup> the company has systems of control in place that are adequate to ensure compliance with:
  - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
- c. the company has complied with:
  - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- d. the company has complied with the Hong Kong Securities and Futures (Financial Resources) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusions 1(a) and 1(c) below, we have performed such procedures as we considered necessary.

[In relation to our conclusion 1(b) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether

relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.<sup>1</sup>

In relation to our conclusion (2) below, we are not required to perform any procedures to search for instances of contravention of the Hong Kong Securities and Futures (Financial Resources) Rules.

### **Inherent limitations**

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

### **Conclusion**

Based on the foregoing:

1. in our opinion:
  - a. the company has correctly compiled the attached returns as referred to in section 3(1)(b) of the Hong Kong Securities and Futures (Accounts and Audit) Rules made up to [*year end date*] from the records of the company;
  - b.<sup>1</sup> during the year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
    - i. sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules;
  - c. during the year ended [*year end date*], the company has complied with:
    - i. section 3 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
    - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
    - iii.<sup>1</sup> sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
2. during the year ended [*year end date*], we are not aware of any instances where the company has contravened the Hong Kong Securities and Futures (Financial Resources) Rules.

### **Use of this report**

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

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable where the licensed corporation does not hold client assets. Refer to paragraph 68 of Appendix 2 for more guidance.*

THE AUDIT OF LICENSED CORPORATIONS AND  
ASSOCIATED ENTITIES OF INTERMEDIARIES

Where the licensed corporation does not hold assets, the auditor is encouraged to include either one of the following paragraphs after the first paragraph of the example compliance report:

- (a) The licensed corporation is subject to the licensing condition that it shall not hold client assets. *[This paragraph is applicable to licensed corporations / associated entities who are not licensed to hold client assets.]*
- (b) The licensed corporation is permitted to hold client assets however no client assets were held during the year. *[This paragraph is applicable to licensed corporations / associated entities who are licensed to but does not hold client assets.]*

### **Example 3 - compliance report by the auditor - associated entity of intermediary**

#### **COMPLIANCE REPORT BY THE AUDITOR TO THE BOARD OF DIRECTORS OF ABC NOMINEE LIMITED**

Pursuant to the Hong Kong Securities and Futures (Accounts and Audit) Rules and section 156 of the Hong Kong Securities and Futures Ordinance, we have been requested to issue this Compliance Report for the year ended [*year end date*] for submission by the company to the Hong Kong Securities and Futures Commission (SFC).

#### **Respective responsibilities of directors and auditor**

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

- a. the company has systems of control in place that are adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - ii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

It is our responsibility to form an independent conclusion on the above, based on our engagement, and to report our conclusion to you.

#### **Basis of conclusion**

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries" issued by the Hong Kong Institute of Certified Public Accountants.

In relation to our conclusion (a) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control 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 year ended [*year end date*], the company had systems of control in place that were adequate to ensure compliance with:
  - i.<sup>1</sup> sections 4, 5, 6, 8(4), 10, 11 of the Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules; and
- b. during the year ended [*year end date*], the company has complied with:
  - i. section 4 of the Hong Kong Securities and Futures (Keeping of Records) Rules;
  - ii.<sup>1</sup> sections 4, 5, 6, 8(4), 10 and 11 of Hong Kong Securities and Futures (Client Money) Rules; and
  - iii. sections 4(4), 5, 10(1) and 12 of the Hong Kong Securities and Futures (Client Securities) Rules.

### **Use of this report**

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

XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
[Address]  
Date

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*Note 1: Not applicable in the case of an associated entity of a registered institution.*

## APPENDIX 2 - CLIENT ASSETS

### INTRODUCTION

1. This Appendix provides more detailed guidance to the auditor on the work normally carried out in order to form an opinion on client assets in the auditor's reporting under the SFO. It provides guidance on the following rules:
  - a. Securities and Futures (Client Securities) Rules (Client Securities Rules);
  - b. Securities and Futures (Client Money) Rules (Client Money Rules);
  - c. Securities and Futures (Keeping of Records) Rules (Keeping of Records Rules); and
  - d. Securities and Futures (Accounts and Audit) Rules.

For the purpose of this Appendix the term "rules" means any of the above applicable rules.

2. The main purpose of the rules in relation to client assets is to ensure that the regulated entity safeguards client assets. A further purpose is to ensure that, in the event of insolvency of the regulated entity, client assets are protected from the claims of its general creditors and, in the case of client money, from any right of set off by institutions which hold the money.
3. The rules require a regulated entity to maintain a high standard of custodianship and associated record keeping. Management of a regulated entity is responsible for establishing and maintaining adequate accounting records and systems and controls. This recognizes the position of trust under which client assets are held.
4. This Appendix is separated into three sections as follows:
  - a. client securities;
  - b. client money; and
  - c. no client assets.

The sections on client securities and client money also set out the relevant planning considerations.

5. This Appendix is to assist the auditor in determining the scope of the work for each individual audit. However it is not intended to limit or replace individual professional judgment, initiative and vigilance. Audit procedures are designed to meet the requirements of the particular situation, giving careful consideration to the size and type of regulated entity and the system of internal accounting control; this is a matter that requires the exercise of professional judgment in the light of the circumstances of each particular case.
6. Where the auditor discovers that the systems have failed or material differences have arisen, it considers the implications these may have on other areas of its work, on its reporting obligations and, in particular, on the "truth and fairness" of the financial statements.

## CLIENT SECURITIES

### Introduction

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

These securities may be held in the form of collateral.

8. The Client Securities Rules do not apply to client securities of a licensed corporation that are in an account established and maintained by a client of the licensed corporation, in that client's name, with a person other than the licensed corporation or an associated entity of the licensed corporation. The Client Securities Rules do not apply to client securities that are received or held outside Hong Kong by a licensed corporation or its associated entity.
9. For the particular regulated activity, the auditor needs to understand what may constitute client securities that are covered by the Client Securities Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client securities, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Securities Rules as a result.

### Planning

10. The auditor's work on client securities will be planned in relation to three reporting requirements. For client securities, the main areas that need to be addressed by the auditor, to enable them to fulfill its reporting requirements, are:
  - a. whether during the 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 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 section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client securities.
11. The control objectives that a regulated entity administering or holding client securities or securities collateral will need to meet and the evidence that may be available to the auditor upon which it can base its conclusions are outlined below. They are only indicative.
12. Not every regulated entity, particularly a smaller one, will be able to meet all these objectives through the establishment of formal controls and segregation of duties. In consequence, not all the evidence indicated below will be available in every case.

13. This does not necessarily mean that the regulated entity has weak controls or that there is insufficient evidence for the auditor to give a conclusion. The regulated entity may well have adequate controls due to close supervision by the management, taking into account the low volume of client securities handled.
14. In some cases, therefore, the auditor may place greater reliance on observation and enquiry for its audit evidence than inspection of documentation. In doing so, it needs to bear in mind that undocumented systems are more prone to error and fraud, and that its presence and enquiries may influence the manner in which procedures are operated at that time.

#### **Adequate systems of control - Timely renewal of standing authorities (section 4(4))**

##### **Control objectives - Timely renewal of standing authorities**

15. The main factors that will be considered are:
  - a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;
  - b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
  - c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

##### **Evidence - Timely renewal of standing authorities**

16. The main factors that will be considered are:
  - a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current standing authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.

#### **Adequate systems of control - Deposit or registration of client securities and securities collateral (section 5)**

##### **Control objectives - Deposit or registration of client securities and securities collateral**

17. The main factors that will be considered are:
  - a. whether registerable client securities are registered in a name permitted by the rules;
  - b. where client securities are deposited in the same name as that used for the intermediary's house positions, that the client securities are deposited in a designated account different from that in which its house positions are deposited;
  - c. securities held as collateral can be separately identified;

- d. arrangements for releasing documents under stock lending and borrowing arrangements are in accordance with the rules;
- e. satisfactory arrangements for ensuring that the client securities were held or securities collateral kept after receipt in a segregated account or registered in the name of the client from whom or on whose behalf the client securities have been received, or the intermediary or associated entity;
- f. satisfactory arrangements for ensuring that where client securities and securities collateral are deposited in safe custody, that the financial institutions, custodians or other intermediaries in question are appropriately authorized, approved or licensed as appropriate;
- g. satisfactory arrangements for withdrawal or disposal of client securities and securities collateral to be made to or by the client, or to or by any authorized party as specified in sections 5 and 6 of the Client Securities Rules upon the circumstances or under discretionary powers given in the client agreement;
- h. risk assessments to be carried out on all custodians to assess the risk of placing client securities and securities collateral with a third party;
- i. written arrangements between the intermediary or associated entity and the custodian covering at least the minimum requirements of the rules; and
- j. an adequate system to ensure that statements are sent to clients at required intervals, and that such statements properly reflect the regulated entity's records.

**Evidence - Deposit or registration of client securities and securities collateral**

18. The main factors that will be considered are:
- a. written instructions from clients stating the manner in which their securities are to be registered; these instructions may be set out in standard client agreements;
  - b. written procedures setting out how each security is to be identified so as to reflect the client's entitlement to that security (e.g. registered in the client's name);
  - c. where client securities are registered in the name of an associated entity, that an appropriate record of the interests of individual clients is maintained;
  - d. clear segregation of client securities from other securities;
  - e. separate registers maintained of securities held as collateral;
  - f. evidence of appropriate authority to engage in stock lending arrangements, given to the regulated entity by the clients concerned;
  - g. separate records of all such transactions sufficient to show the details of the stocks lent at any time and the collateral held;
  - h. proper segregation of duties which ensure each area is staffed by people independent of any other operations and password controls;
  - i. qualifications and experience of senior management;
  - j. strong boxes, fire-proof rooms and safes, restricted access via password controlled doors or limited access to keys, especially where important documents like securities certificates, were kept in the office premise;
  - k. regular stock reconciliations performed for each stock segregated account against third party supporting documents;

- l. follow up actions taken by the licensed corporation on any reconciling or unusual entries in the stock records, particularly negative stock balances;
- m. evidence of spot checks of the custodian area by the compliance or internal audit department;
- n. written procedures stating how custodian staff are to process the movement of securities and what is required in the form of authorization;
- o. evidence of procedures for selection of external financial institutions, custodians or other intermediaries to ensure that they are eligible and suitable to hold client securities and securities collateral in safe custody;
- p. results of a risk assessment process including external information on credit rating, financial results etc. and internal information on customer service received;
- q. letters of agreement with custodians stating the terms under which they are operating;
- r. file copies of statements sent to clients, which agree with the records; and
- s. procedures and controls (e.g. completed checklist) to ensure that all clients receive a statement (where required).

**Adequate systems of control - Depositing and transferring client securities and securities collateral (section 10(1))**

19. Under section 10(1) of the Client Securities Rules a regulated entity is required to take reasonable steps to ensure that client securities and securities collateral of the intermediary are not:
  - i. deposited;
  - ii. transferred;
  - iii. lent;
  - iv. pledged;
  - v. repledged; or
  - vi. otherwise dealt with,

except as provided in Part 2 of the Client Securities Rules.

The relevant elements of the Client Securities Rules in Part 2 (covering sections 5, 6, 7, 8 and 9) in summary cover the following:

- a. *Section 5 - requirements for deposit or registration of client securities and securities collateral*

Unless client securities and securities collateral are registered in the name of the client, or the associated entity (or the intermediary in the case of securities collateral):

- i. client securities are:
  - deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities;

- ii. securities collateral is:
  - deposited in safe custody in a segregated account which is designated as a trust account or client account in Hong Kong with an authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities; or
  - deposited in an account in the name of the intermediary or associated entity with authorized financial institution, an approved custodian or another intermediary licensed for dealing in securities.

*b. Section 6 - dealings with client securities and securities collateral*

A regulated entity may deal with client securities or securities collateral in accordance with:

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

Where a licensed corporation is licensed for asset management, with the written agreement of the client, 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, a licensed corporation may dispose, or initiate a disposal by any of its associated entities, of any of the client securities or securities collateral in settlement of that liability.

*c. Section 7 - treatment of client securities and securities collateral by intermediaries licensed for dealing in securities and their associated entities*

With a standing authority a licensed corporation licensed for dealing in securities may:

- i. apply any of the securities or securities collateral pursuant to a securities borrowing or lending agreement;
- ii. subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, deposit any of the securities collateral in question with an authorized financial institution as collateral for financial accommodation provided; or
- iii. deposit any of the securities collateral in question with a recognised clearing house or another intermediary as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.

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

Subject to the requirement of having repledged securities not exceeding 140% of aggregate margin loans, with a standing authority a licensed corporation licensed for securities margin financing may deposit any of the securities collateral that it receives with an authorized financial institution or an intermediary licensed for dealing in securities as collateral for financial accommodation provided to the licensed corporation.

- e. *Section 8A – repledging*

- i. A regulated entity is required to ascertain the closing aggregate market value of the repledged securities collateral for each business day does not exceed 140% of its aggregate margin loan on the same date;
- ii. If such 140% limit has been exceeded on any business day, the regulated entity is required to withdraw any excess to reduce such ratio to below the limit by the end of the next business day.

- f. *Section 9 - treatment of securities collateral by intermediaries licensed for dealing in futures contracts and their associated entities*

With a standing authority a licensed corporation licensed for dealing in futures contracts may deposit any of the securities collateral that it receives with a recognised clearing house or an intermediary licensed for dealing in futures contracts as collateral for the discharge and satisfaction of the licensed corporation's settlement obligations and liabilities.

**Control objectives - Depositing and transferring client securities and securities collateral**

20. The control objectives that have been included in paragraph 17 above apply here. Additional factors that will be considered are:
- a. written procedures in place covering client dealing and transfer instructions;
  - b. controls provide assurance that client instructions are authorized prior to being actioned;
  - c. standing authorities are valid and current;
  - d. transfers of client securities and securities collateral are made to appropriate authorized accounts;
  - e. controls provide assurance that at the end of each business day repledged securities does not exceed 140% of aggregate margin loans; and
  - f. where a client has failed to deliver the stock to the licensed corporation to settle his sale order, the securities of other clients are not used to settle the obligations of the client except as provided in Part 2 of the Client Securities Rules.

**Evidence - Depositing and transferring client securities and securities collateral**

21. The main factors that will be considered are:
- a. availability of up-to-date written procedures covering the handling of client instructions;
  - b. evidence that client instructions are verified as authentic and valid before being actioned;
  - c. evidence that client standing orders are checked that they are current and cover the transaction in question each time they are used;



- d. evidence that where appropriate client securities and securities collateral are only transferred to or deposited with authorized financial institutions, approved custodians or other intermediaries licensed for dealing in securities;
- e. where the licensed corporation has both cash clients and margin clients, the auditor should check whether separate designated accounts are maintained;
- f. where client securities are maintained through CCASS, to determine whether securities received are allocated and transferred to the appropriate account within the timeframe as specified by the rules;
- g. whether the licensed corporation has taken effective actions to follow up on any negative stock balance in its stock records and client ledger; and
- h. the maximum amount of securities that the licensed corporation is permitted under section 8A of the Client Securities Rules to repledge is calculated on an ongoing basis and compared with the aggregate value of securities actually repledged, and rectification action is carried out within the statutory timeframe for any breach of the limit.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 12)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

22. The main factors that will be considered are:
- a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined in section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

23. The main factors that will be considered are:
- a. evidence that the business has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

**Compliance with the rules**

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

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

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

### **Adequate accounting records have been maintained**

#### **Control objectives - Adequate accounting records have been maintained**

25. The main factors that will be considered are:
- a. proper and prompt recording of the movements of documents (this includes all documents, including those relating to the regulated entity's own securities as there is a risk of teeming and lading and having client documents mixed with the regulated entity's own documents);
  - b. proper and prompt recording of all purchases and sales of securities on behalf of clients;
  - c. records in agreement with the statements sent to clients of assets held on their behalf;
  - d. reconciliations carried out in accordance with the rules; and
  - e. proper and prompt accounting for benefits, such as bonus or scrip issues accruing to clients.

#### **Evidence - Adequate accounting records have been maintained**

26. The main factors that will be considered are:
- a. evidence that documents of title are recorded immediately on receipt;
  - b. evidence that documents of title are not released from the regulated entity's control to clients, registrars, brokers, etc. without the records being amended;
  - c. records kept in respect of any document clearly setting out the date of receipt and despatch of the document, the nature of the document, the client to whom the document relates, and the nature, amount and nominal value of the securities to which the document relates;
  - d. evidence that statements are sent to clients at the required intervals, made up to the appropriate date, and properly specifying the documents held. In this context, the auditor may consider obtaining direct confirmation from clients;
  - e. evidence that correspondence from clients querying statements (including client complaints) and any other queries have been dealt with properly and promptly;
  - f. evidence that benefits such as dividends or scrip issues are collectively and correctly allocated to each client;
  - g. evidence that reconciliations have been carried out in accordance with the rules (for more detailed guidance on reconciliations see paragraphs 28 to 36 below); and
  - h. circularisation of account balances in accordance with paragraph 27 below.

27. The auditor exercises its professional judgment to determine whether and how to go about the performance of a circularisation of clients' account balances. The SFC has issued a list of matters which may be taken into account by the auditor in conducting a circularisation of clients' account balances:
- a. the auditor would exercise its judgment in determining sufficient coverage of samples over the total population of clients' accounts both in terms of number of clients and the money value of clients' assets;
  - b. a risk-based approach should be adopted for sampling client accounts for circularisation whereby greater emphasis is placed on accounts which are more susceptible to misstatement or frauds, such as accounts under an arrangement to hold mail or to direct mail to the address of management or staff of the licensed corporation, inactive and dormant accounts etc;
  - c. appropriate audit steps should be taken to ensure the completeness of the list of clients from which samples are drawn;
  - d. confirmation would be prepared in language that the clients of the regulated entity are familiar with;
  - e. confirmation would be directly sent to and received from clients. Clients would be provided with convenient means of responding to the auditor;
  - f. be aware of any client enquiries regarding any discrepancies in their account balances;
  - g. the auditor would independently select samples for circularisation;
  - h. the auditor should ensure that the client particulars (such as the name and address of the client) stated in statements of account to be sent to the clients for confirmation agree to the licensed corporation's latest client information. Furthermore, the auditor should also ensure that the account balances and securities holding in the statements of account sampled for confirmation are consistent with the licensed corporation's relevant records. For example, holdings in each stock as stated in the statements of account should be checked against the underlying accounting records and stock ledgers, which should be reconciled with custodians' statements and/or physical stock count results with discrepancies properly followed up.
  - i. to improve the number of replies it is advisable to send the confirmation out as close as possible to the date that the licensed corporation has sent out its monthly statements.
  - j. the auditor to determine appropriate procedures in assessing the reliability of the confirmation letters received such as verifying client signatures on the confirmation against client agreements and/or directly calling the clients to verify the agreed balances on a sample basis; and
  - k. adequate and timely follow-up procedures for the non-reply confirmations would be carried out such as considering sending reminders or directly calling the non-reply clients etc. and/or reviewing a sample of trade orders and withdrawals of funds and securities recorded in their accounts.

## Reconciliations

28. The requirement to carry out reconciliations is set out in the Keeping of Records Rules.

*Control objectives - Reconciliation of client securities - Physically held client securities*

29. The main factors that will be considered are:

- a. physical counts and reconciliations of all securities performed with at least the frequency and in the manner required by the rules, and by staff (in so far as possible) independent of the custodian department;
- b. procedures planned and implemented to ensure that the count of client title documents is accurate;
- c. timely clearance of reconciling items; and
- d. records retained of the dates and results of the physical counts.

*Evidence - Reconciliation of client securities - Physically held client securities*

30. The main factors that will be considered are:

- a. detailed instructions for the counts;
- b. an independent function (such as compliance department or internal audit) organizing, controlling or participating in carrying out the counts and reconciliations;
- c. sufficient time and resources devoted to the counts and reconciliations;
- d. full and clear documentation of the counts and reconciliations;
- e. counts carried out at the frequency and with the time limits required by the rules;
- f. adequate explanations for reconciling items; and
- g. completion of reconciliations (i.e. all items explained).

*Control objectives - Reconciliation of client securities - Client securities held by a custodian*

31. The main factors that will be considered are:

- a. reconciliations for all custodians performed with at least the frequency and in the manner required by the rules;
- b. timely clearance of reconciling items;
- c. the reconciliations undertaken by a person who is not involved with the recording or movement of the assets, if the size of the regulated entity permits this segregation of duties; and
- d. records retained of the dates and results of reconciliations including confirmations from external custodians.

*Evidence - Reconciliation of client securities - client securities held by a custodian*

32. The main factors that will be considered are:

- a. an independent function carrying out the reconciliations;
- b. sufficient time and resources devoted to reconciliations;

- c. full and clear documentation of the reconciliations;
  - d. reconciliations carried out at the frequency required by the rules;
  - e. adequate explanations for reconciling items; and
  - f. completion of reconciliations (i.e. all items explained).
33. Where client securities are physically held by the regulated entity itself, the auditor may attend part or all of one of the physical counts of client title documents. In reaching a conclusion regarding the extent to which this is necessary, the auditor considers the strength of controls surrounding, and the independence of, the count, reconciliation, day to day processing and custody of client documents of title.
34. The auditor examines confirmations from independent custodians of documents of title held by them.
35. The auditor inspects correspondence and agreements with custodians in order to verify compliance with the rules.
36. In larger regulated entities, a rolling reconciliation basis of confirming client title documents (similar to a manufacturing company's system of perpetual stock-taking) is sometimes adopted. Care must be taken to ensure that systems and controls are in place to prevent teeming and lading.

## CLIENT MONEY

### Introduction

37. The Client Money Rules apply to client money of a licensed corporation that is received or held by or on behalf of:
- a. the licensed corporation, in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or
  - b. an associated entity of the licensed corporation where such an associated entity is not an authorized financial institution, in relation to such conduct of the regulated activity.
- The Client Money Rules do not therefore apply to associated entities of registered institutions. The reference to "regulated entity" in this section below is therefore restricted to a licensed corporation or its associated entity that is not an authorized financial institution.
38. The Client Money Rules do not apply to client money of a licensed corporation that is received or held outside Hong Kong by the licensed corporation or an associated entity of the licensed corporation.
39. The Client Money Rules do not apply to client money of a licensed corporation that is in a bank account established and maintained by a client of the licensed corporation in that client's name.
40. For the particular regulated entity, the auditor needs to understand what may constitute client money that is covered by the Client Money Rules. It would consider all situations and transaction types that may be entered into by the regulated entity. Although the regulated entity may consider that a particular area is not covered by the rules relating to client money, the auditor needs to be alert to situations where this is incorrect and the regulated entity is in breach of the Client Money Rules as a result.

### **Segregated accounts**

41. When a regulated entity holds or expects to hold client money, it must open one or more segregated accounts, each of which shall be designated as a trust account or client account. These must be established and maintained with:
  - a. an authorized financial institution; or
  - b. any other institution approved by the SFC for the purposes of the Client Money Rules, either generally or in a particular case.

### **Planning**

42. The auditor's work on client money will be planned in relation to the three reporting requirements. For client money, the main areas that need to be addressed by the auditor, to enable it to fulfil its reporting requirements are:
  - a. whether during the 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 section 3 or 4 of the Keeping of Records Rules to the extent that they relate to client money.
43. The control objectives that the auditor would expect to see in a regulated entity holding client money and the evidence from which the auditor seeks to draw reasonable conclusions are outlined below. They are only indicative and will not be applicable to all regulated entities holding client money, especially smaller ones.

### **Adequate systems of controls - Payment of client money into segregated accounts (section 4)**

44. Client money held by regulated entities has to be held on trust for clients in one or more segregated bank accounts designated as a trust account or client account.

#### **Control objectives - Payment of client money into segregated account**

45. The main factors that will be considered are:
  - a. all client money is paid within one business day into a segregated account;
  - b. bank accounts opened only with an authorized financial institution, or any other institution approved by the SFC for the purposes of the Client Money Rules;
  - c. bank accounts include "Client Account" or "Trust Account" in their description in accordance with section 4(1) of the Client Money Rules;
  - d. appropriate statements, confirmations and agreements sent to and received from the authorized financial institutions;
  - e. systems are adequate to identify all client money;
  - f. systems are adequate to ensure that all client money and only client money is paid in compliance with the rules (other than where it is specifically allowed by the rules);

- g. systems are adequate to ensure that all client money is paid in promptly; that is within one business day, unless otherwise disposed of in accordance with the rules; and
- h. client money is only applied for the purposes of the client to whom it relates.

**Evidence - Payment of client money into segregated accounts**

46. The main factors that will be considered are:
- a. clear internal instructions setting out the procedures to be followed in dealing with any potential client money;
  - b. suitable levels of staff (i.e. with the appropriate training and experience) responsible for establishing segregated accounts and identifying client money within the regulated entity;
  - c. lodgements regularly and promptly made;
  - d. lodgements to segregated accounts comprise client money only, except as otherwise permitted;
  - e. lodgements to non client accounts do not include client money;
  - f. an up to date list of all bank accounts which identifies those that are segregated accounts; and
  - g. bank statements agreeing to the regulated entity's records.

**Adequate systems of controls - Payment of client money out of segregated accounts (section 5)**

**Control objectives - Payment of client money out of segregated accounts**

47. The main factors that will be considered are:
- a. systems are adequate to ensure that all client money withdrawals in Hong Kong are made in compliance with the rules; and
  - b. all withdrawals from segregated accounts are made only for prescribed purposes and in accordance with the rules.

**Evidence - Payment of client money out of segregated accounts**

48. The main factor that will be considered is:
- a. withdrawals are properly authorized and for purposes approved by the rules.

**Adequate systems of controls - Treatment of interest on client money held in segregated accounts (section 6)**

49. The Client Money Rules require that interest derived from client money is held in a segregated account. To the extent that any amount of interest retained in a segregated account which the regulated entity is entitled to retain under an agreement with the client(s), this would be paid out of the account within one business day after the interest is credited to the account or the regulated entity becomes aware that the interest has been credited to the account.

**Control objectives - Treatment of interest on client money held in segregated accounts**

50. The main factors that will be considered are:
- a. appropriate procedures in place for identifying and withdrawing regulated entity's entitlement of interest on segregated accounts on a timely basis;
  - b. where applicable, interest paid on all money subject to interest calculations; and
  - c. interest payments correctly calculated by reference to the appropriate dates.

**Evidence - Treatment of interest on client money held in segregated accounts**

51. The main factors that will be considered are:
- a. evidence that regulated entity's interest entitlements are withdrawn on a timely basis in accordance with the rules; and
  - b. schedules showing how interest due to clients has been calculated (or equivalent computer processes).

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

**Control objectives - Timely renewal of standing authorities**

52. The main factors that will be considered are:
- a. satisfactory arrangements for ensuring that standing authorities that are due for renewal are identified;
  - b. satisfactory arrangements for notifying clients that their standing authorities are due to expire and informing them that unless clients object, they will be renewed upon the same terms and conditions; and
  - c. satisfactory notification to clients of the renewal of the standing authorities within the specified time frame.

**Evidence - Timely renewal of standing authorities**

53. The main factors that will be considered are:
- a. retention of client standing authorities in a secure environment;
  - b. tracking system for timely identification of standing authorities that are approaching expiry;
  - c. management review of standing authority renewal notices prior to despatch;
  - d. client relationship personnel follow up expiring standing authorities with clients to ensure they have received notifications;
  - e. evidence of spot checks of standing authorities by the compliance or internal audit department to ensure that current authorities are in place; and
  - f. evidence of procedures for ensuring that standing authority renewal notices have been provided within one week after expiry.



**Adequate systems of controls - Requirement to pay money other than client money out of segregated accounts (section 10)**

54. The Client Money Rules require that a regulated entity which becomes aware that it is holding an amount of money in a segregated account that is not client money of the regulated entity shall, within one business day of becoming so aware, pay that amount of money out of the segregated account.

**Control objectives - Requirement to pay money other than client money out of segregated accounts**

55. The main factor that will be considered is appropriate procedures in place for identifying and withdrawing regulated entity's money from segregated accounts on a timely basis.

**Evidence - Requirement to pay money other than client money out of segregated accounts**

56. The main factor that will be considered is evidence that regulated entity's money is withdrawn on a timely basis in accordance with the rules.

**Adequate systems of control - Reporting of non-compliance with certain provisions of the rules (section 11)**

**Control objectives - Reporting of non-compliance with certain provisions of the rules**

57. The main factors that will be considered are:
- a. system in place to identify potential incidents of non-compliance with the rules;
  - b. potential incidents of non-compliance reported to management on a timely basis; and
  - c. matters of non-compliance (a reportable matter as defined by section 157 of the SFO) are reported to the SFC in writing within one business day.

**Evidence - Reporting of non-compliance with certain provisions of the rules**

58. The main factors that will be considered are:
- a. evidence that the regulated entity has a system in place to identify potential incidents of non-compliance with the rules;
  - b. level of awareness amongst staff of the rules;
  - c. records kept in relation to potential incidents of non-compliance demonstrating that these have been reported to management on a timely basis; and
  - d. evidence that matters of non-compliance have been reported to the SFC in writing within one business day.

**Compliance with the rules**

59. The work that the auditor will have performed as outlined above in relation to determining whether during the 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 auditor to issue its conclusion on the regulated entity's compliance with the rules during the period under review.

The auditor would consider obtaining written representations from management that all incidents of non-compliance with the rules have been disclosed, or that there have been no incidents of non-compliance.

### **Adequate accounting records have been maintained**

#### **Control objectives - Adequate accounting records have been maintained**

60. The main factors that will be considered are:
- a. proper recording of movements of client money;
  - b. interest credited in accordance with the rules;
  - c. reconciliations carried out in accordance with the rules; and
  - d. appropriate titles are given to accounts.

#### **Evidence - Adequate accounting records have been maintained**

61. The main factors that will be considered are:
- a. adequate details of the day to day entries of money paid into and out of the segregated accounts and individual client accounts including:
    - i. dates of receipts and payments;
    - ii. name of the client;
    - iii. name of the person from whom money was received or to whom it was paid, if other than the client;
    - iv. sub-ledgers with individual client accounts; and
    - v. evidence of designation from a client;
  - b. records of the interest earned on the segregated accounts, the determination of the amount of interest payable to clients and the dates and amounts of interest paid/credited to clients;
  - c. records maintained on a timely basis;
  - d. evidence that reconciliations have been carried out as required and reconciling items have been investigated and cleared promptly (for more detailed guidance on reconciliations see paragraphs 62 to 67 below);
  - e. the records maintained comply with the guidance given by the SFC;
  - f. to provide third party evidence of client balances (except settlement balances), the auditor may consider obtaining direct confirmation from clients; in practice, this may be conveniently combined with testing the accuracy of statements of their securities sent to clients; and
  - g. circularisation of account balances in accordance with paragraph 27 of this Appendix.

## Reconciliations

62. The requirement to carry out reconciliations is set out in the Keeping of Records Rules.
63. Regulated entities that hold client money are required to reconcile each month any differences during that month in its balances or positions with any of their associated entities and other parties, including:
- a. recognised exchange companies;
  - b. clearing houses;
  - c. other intermediaries;
  - d. custodians; and
  - e. banks,
- and show how such differences were resolved.

### *Control objectives – Reconciliation*

64. The main factors that will be considered are:
- a. client/trust money per the segregated account, as recorded by the regulated entity, is reconciled with the total of balances recorded as due to each client at least each month;
  - b. balance of each such segregated account, as recorded by the regulated entity, is reconciled with the relevant bank statements;
  - c. the reconciliations are properly prepared and adequate explanations given for reconciling items, which would be cleared without delay; and
  - d. records are retained of the dates and results of the reconciliations.

### *Evidence – Reconciliation*

65. The main factors that will be considered are:
- a. an up-to-date list of the segregated accounts held that agrees with the segregated accounts being reconciled;
  - b. evidence of an independent preparation and review of these reconciliations; and
  - c. reconciliations being carried out regularly over the period under review.
66. The auditor carries out normal audit tests on bank reconciliations. Particular attention will be paid to reconciling items, ensuring that outstanding and uncleared items are properly identified and are duly cleared shortly after the reconciliation. As part of its substantive testing, the auditor examines and where appropriate obtain direct confirmation of bank balances from each bank concerned.
67. The regulated entity would also reconcile its segregated bank accounts as often as necessary but at least once every month. Some regulated entities need to reconcile segregated accounts daily if the volume of business is high.

## NO CLIENT ASSETS

68. The auditor must be alert to a situation where a licensed corporation is not permitted under its licensing condition to hold client assets or does not, as a matter of policy, hold client assets. Where this is the case, the licensed corporation would have systems in place to avoid receiving and holding client assets.
69. Although the auditor is not required to give the SFC independent assurance that the licensed corporation has not administered or held client assets, it still considers carrying out the following procedures:
  - a. enquire as to what arrangements a licensed corporation has in place to ensure that relevant staff are aware of what constitutes client assets. This could be documented in a procedural manual or internal memorandum and would outline the procedures to be followed if client assets are identified;
  - b. enquire as to how settlements are effected on behalf of clients (reference will be made to client documentation and payment instructions on contract notes or statements);
  - c. review the cash book in order to confirm that receipts and payments in the cash book only relate to the licensed corporation's own money and that no client money is being received or held;
  - d. review the licensed corporation's client files to see whether they provide any indication that it has held client assets in order to undertake a particular transaction;
  - e. review client agreements for statements of how custody is to be operated; as a corollary, review the agreements with any custodians used and the counterparty files (i.e. the documentation which supports the securities transactions) for correspondence on settlement procedures to ensure that there is no evidence that the licensed corporation has offered client money protection (i.e. held separately in accordance with the rules);
  - f. ascertain whether a system of review exists to ensure that client assets are not administered or held. This could constitute periodic review by the internal auditor or compliance officer and encompasses substantive review of the licensed corporation's bank accounts and client agreements; and
  - g. enquire as to details of any client money the licensed corporation has received and the action taken.
70. The auditor will consider obtaining written representations from management that the licensed corporation has not breached any rules relating to the client assets during the period under review.