

T. K. LO & COMPANY

SEMINAR ON THE AUDIT OF LICENSED CORPORATIONS AND ASSOCIATED ENTITIES OF INTERMEDIARIES (PRACTICE NOTE 820)

4 March 2011

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1. INTRODUCTION

Under the licensing and registration regime of Chapter 571 Securities and Futures Ordinance (“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 Securities and Futures Commission (“SFC”).

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.

The Practice Note 820 (“PN820”) was issued to help us to deal with the audit works for the regulated clients. PN820 has just been revised in December 2010. Other than aligning with the clarified audit standards, a new topic for Cessation of Activities is added.

This handout will focus on the regulated entity that do not hold any client’s assets (i.e. type 4,5,6 & 9 with restricted activities). However, if we have found that the client had ever held any client’s assets, we should investigate the matter no matter how immaterial the amount was as it may indicate that the client has already violated the SFO.

2. DEFINITIONS

SFO	Securities and Futures Ordinance (Chapter 571)
SFC	Securities and Futures Commission
LC	Licensed corporation (As defined in Schedule 1 of the SFO)
PN820	Practice Note 820, HKICPA Handbook Volume III
AAR	Securities and Futures (Accounts and Audit) Rules (Chapter 571P)
FRR	Securities and Futures (Financial Resources) Rules (Chapter 571N)
KRR	Securities and Futures (Keeping of Records) Rules (Chapter 571O)

Registered institution

It is an authorized financial institution which is registered under Part V of the SFO.

Regulated entity

A licensed corporation or an associated entity of an intermediary.

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.

Client's assets

(客戶資產) means-

- (a) client securities and collateral; and
- (b) client money;

3. LEGISTRATION AND REGULATORY REQUIREMENTS

SFO is designed to protect investors

SFC administers the regulation of regulated activities and assumes the duties of frontline regulator of LCs and is responsible for investigations and disciplinary matters under SFO, subsidiary legislation, codes and guidelines.

3.1 9 types of regulated activities (Schedule 5 of SFO)

Type 1: dealing in securities

Type 2: dealing in futures contracts

Type 3: leveraged foreign exchange trading

Type 4: advising on securities (就證券提供意見)

means-

(a) giving advice on-

(i) whether;

(ii) which;

(iii) the time at which; or

(iv) the terms or conditions on which,

securities should be acquired or disposed of; or

(b) issuing analyses or reports, for the purposes of facilitating the recipients of the analyses or reports to make decisions on-

(i) whether;

(ii) which;

(iii) the time at which; or

(iv) the terms or conditions on which,

securities are to be acquired or disposed of, otherwise than by ...

Type 5: advising on futures contracts

Type 6: advising on corporate finance (就機構融資提供意見)

means giving advice-

(a) concerning compliance with or in respect of rules made under section 23 or 36 of this Ordinance governing the listing of securities and the code published under section 399(2)(a) or (b) of this Ordinance;

(b) concerning-

(i) any offer to dispose of securities to the public;

(ii) any offer to acquire securities from the public; or

(iii) acceptance of any offer referred to in subparagraph (i) or (ii), but only in so far as the advice is given generally to holders of securities or a class of securities; or

(c) to a listed corporation or public company or a subsidiary of the corporation or company, or to its officers or shareholders, concerning corporate restructuring in respect of securities (including the issue, cancellation or variation of any rights attaching to any securities), otherwise than by ...

Type 7: providing automated trading services

Type 8: securities margin financing; and

Type 9: asset management – means -

(a) real estate investment scheme management; or

(b) securities or futures contracts management

Type 10: providing credit rating services (to be effective on 1 June 2011)

3.2 Regulatory Requirements

3.2.1 Licensing and registration – requirement

Licensing Requirement – Professional Exemptions

If you are a solicitor, a counsel or a **certified public accountant**, you are not required to be licensed for Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) or Type 9 (asset management) regulated activity if you provide such advice or services **wholly incidental** to your practice as a solicitor, a counsel or a certified public accountant.

3.2.2 Business conduct – code of ethics

The Nine basic principles for business conduct cover:

- (a) Honesty and fairness
- (b) Diligence
- (c) Capabilities
- (d) Information about clients
- (e) Information for clients
- (f) Conflicts of interest
- (g) Compliance
- (h) Client assets; and
- (i) Responsibility of senior management

3.2.3 Client assets – segregation

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. (para 23)

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. (para 24)

3.2.4 Record keeping

The Securities and Futures (Keeping of Records) Rules

3.2.5 Financial resources requirements – minimum net assets value in any time

Liquid capital

A LC should at all times maintain minimum liquid capital. The minimum liquid capital for LC carrying out type 4,5,6 and / or 9 regulated activity without holding

client's assets is HK\$100,000.

4. THE AUDIT OF FINANCIAL STATEMENTS

The practice note has listed out the area we should pay attention to while applying the Hong Kong Standards on Audit (HKSA):

4.1 HKSA 210 Agreeing the Terms of Audit Engagements

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (HKSA 210 para 9)

The engagement letter (for issuing independent auditor's report and compliance report) should also cover reporting requirements.

"Whistle-blower obligation" – the auditor may sometimes consider it necessary to report directly to SFC without the client's prior knowledge or consent.

4.2 HKSA 240 The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements

In accordance with HKSA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions account balances and disclosures. (HKSA 240 para 25)

Requirements

- i) Professional skepticism – notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance
- ii) Discuss among the engagement team

List of fraud risk factors

e.g.

- i) Backlogs in key reconciliations
- ii) Inadequate segregation of duties between the front, middle and back office staff

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

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements (HKSA 250 para 13)

The engagement team should have a general understanding of the applicable laws, codes and regulations before commencing the audit, for example:

- (a) Money Laundering – as defined in SFO
- (b) Codes, guidelines and press releases issued by the SFC

We have no direct reporting responsibility in respect of the codes and guidelines issued by the SFC. However, breaches of such codes and guidelines may give rise to claims by investor or going concern issue.

Other than observing the laws and regulations, the engagement team should also have a general understanding of client's control environment and obtain a written representation from management that they have complied with all the relevant laws, codes and regulations imposed by the SFC.

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

The auditor shall communicate the following matters with those charged with governance:

- The auditor's responsibilities in relation to the financial statement audit (HKSA 260 para 14);
- Planned scope and timing of the audit (HKSA 260 para 15);
- Significant findings from the audit (HKSA 260 para 16); and
- In the case of listed entities, auditor independence (HKAS 260 para 17)

HKSA265 Communicating Deficiencies in Internal Control to those Charged with Governance and Management

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (HKSA 265 para 9)

Those Charged with Governance—The person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity (HKSA 260 para 10(a)).

Management—The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some of all of those charged with governance, for example, executive members of a governance board, or an owner-manager (HKSA 260 para 10(b)).

Requirement

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:

In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and

Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The SFC may request copies of our management letters from regulated entities. We should include a statement in its report to directors or management as follows:

- The management letter has been prepared for the sole use of the regulated entities;
- It must not be disclosed to a third party (except to SFC), or quoted or referred to,

- without the written consent of the auditor; and
- No responsibility is assumed by the auditor to any other person.

We should discuss promptly with appropriate management of the client when we find something that may possibly breach of laws and rules issued by the SFC.

Matters that are neither required to report to SFC under the statutory duty provisions of the SFO, nor required to give qualified opinion should be included in the management letter.

4.5 HKSA 300 Planning an Audit of Financial Statements

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan (HKSA 300 para 7)

HKSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (HKSA 315 para 5)

The competency of the audit engagement team

Risk assessment procedures are defined as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. (HKSA 315 para 4(d))

We should assess the adequacy of the internal controls of each regulated entity to assess the level of the inherent risk of material misstatement. Factors for consideration are listed page 15 of PN820.

4.6 HKSA 320 Materiality in Planning and Performing an Audit

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. (HKSA 320 para 10)

The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (HKSA 320 para 11)

For the purposes of the HKSAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statement as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or level for particular classes of transactions, account balances or disclosures. (HKSA 320 para 9)

There is **no materiality concept** outlined in the SFC's rules in respect of the

Compliance Report. - any breach of the Account and Audit Rules must be reported.

Reconciliation should be provided in the Compliance Report for immaterial discrepancies between the submitted Financial Resources Report and the financial statements.

No need to report the discrepancies in Audit Questionnaire if it is deemed to be immaterial.

4.7 HKSA 402 Audit Considerations Relating to an Entity Using a Service Organization

The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. (HKSA 402 para 11)

4.8 HKSA 505 External Confirmations

The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. (HKSA 505 para 16)

Bank confirmations, unrelated debtor/ creditors' confirmations are strong evidence..

4.9 HKSA 560 Subsequent Events

Subsequent events are defined as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. (HKSA 560 para 5(e))

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (HKSA 560 para 6)

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- a. Discuss the matter with management and, where appropriate, those charged with governance.
- b. Determine whether the financial statements need amendment and, if so,
- c. Inquire how management intends to address the matter in the financial statements. (HKSA 560 para 10)

We should review the correspondence between the SFC and the regulated entity since the period end, and make enquiries of management to determine any breaches have

4.10 come to light since the period end.
HKSA 570 Going Concern

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (HKSA 570 para 2)

Any breaches of the law, codes and guidelines will have going concern issue as SFC can revoke the license of the regulated entity.

We should report to the SFC directly under our statutory duties if we doubt the ability of the regulated entity to continue as a going concern.

Area to be considered:

- i) regulatory censure or fines
- ii) regulatory capital shortages
- iii) visits from the SFC
- iv) reputation and other indicators (including client complaints)
- v) general non-compliance with the law, codes and guidelines; and
- vi) unusual movements in the financial markets

Cessation audit – cease of carrying on all of the regulated activities licensed

4.11 HKSA 580 Management Representations

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (HKSA 580 para 9)

The following points should be added in the letter of representation:

- (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 us all correspondence and notes of meetings with the SFC (except for correspondence subjected to section 378 of the SFO where no consent has been given by the SFC for the licensed corporation to disclose such correspondence to the auditor, if applicable) 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 KRR, the client asset rules and the FRR have been complied with.

5 AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

5.1 Management's responsibilities

- are to prepare:

- i) Annual financial statements with GAAP
- ii) Applicable returns
- iii) Account Disclosure Document
- iv) A business and risk management questionnaire

- Design and maintenance of the systems of control

5.2. Auditor's responsibilities

Auditors' Responsibilities under the AAR

- 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.

5.2.1 The Independent Auditor's Report (Appendix 1 of PN820) is required to state:

- whether the financial statements give a true and fair view
- whether the financial statements are in accordance with the records kept by the regulated entity under the KRR and satisfy the requirements of the AAR;

5.2.2. The Compliance Report (Appendix 1 of PN820) is required to state:

- (a) in the case of a LC, whether the required returns made up to the last day of the financial year as detailed in section 3(1)(b) of the AAR have been correctly compiled from the records of the LC or, if not correctly compiled, the nature and extent of the incorrectness
- (b) during the financial year in question, the regulated entity has complied with the KRR; and
- (c) whether there appears to have been any contravention of the FRR by the LC during the financial years in question

The Compliance Report should be conducted in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Audits or Reviews of Historical Financial Information" issued by the HKICPA.

It is highly desirable that the compliance report is dated with the same date as the Independent Auditor's Report on the financial statements.

6. OTHER REPORTING CONSIDERATIONS

6.1 Audit Questionnaires and Account Disclosure Document

Submission of AQ to the SFC is on a voluntary basis. We are expected to complete the AQ based on information obtained during the course of our audit of the financial

statements covered by the AQ.

In the AQ, we are requested by the SFC to state whether we are satisfied that no material inconsistency between the audited financial statements and the additional disclosure of financial information as required by the Account Disclosure Document for LC came to our attention.

7 COMMUNICATIONS BETWEEN THE AUDITOR AND THE SFC

- Section 157
Auditors of licensed corporations or associated entities of intermediaries to lodge report with Commission, etc in certain cases
- Section 158
Immunity in respect of communication with Commission, etc by auditors of licensed corporations or associated entities of intermediaries
- Section 378
Preservation of secrecy, etc.

8 REPORTING REQUIREMENTS

- 8.1 The requirements mentioned in this section are for LC carrying out type 4,5,6 and / or 9 regulated activity(ies) without holding client's assets
- 8.2 The audited financial statements together with the independent auditor's report must be submitted to the SFC not later than 4 months after the end of the financial year to which they relate. If the LC ceases to carry on all the regulated activities, it should notify the SFC within 7 business days by completing Form No 5 and submit its audited account to the SFC within 4 months after the date of cessation.
- 8.3 Extension of deadline for submission of audited accounts and change of the financial year requires prior approval of the SFC. The application should be submitted together with an application fee well before the deadline.
- 8.4 The LC should also notify the SFC within 7 business days by completing Form 5 if it intends to change auditor. Section 154 states that the LC shall within One business day notify the SFC by notice in writing of proposed change of auditors.
- 8.5 The LC should submit semi-annual financial resources returns to the SFC no later than 3 weeks after the end of the period concerned (i.e. for the periods ended 30 June and 31 December respectively), a return, in the form specified by the Commission under section 402 of the Ordinance, which includes
- i) its liquid capital computation, as at the end of the 6 month period;
 - ii) its required liquid capital computation, as at the end of the 6 month period;
 - iii) an analysis of its profit and loss account;
 - iv) an analysis of its clientele, as at the end of the 6 month period; and
 - v) where it is licensed for Type 9 regulated activity, an analysis of the assets under its management, as at the end of the 6-month period.

9 REFERENCE

- 8.1 The SFC's web site: <http://www.sfc.hk>
- 8.2 Bilingual Laws Information System: <http://www.legislation.gov.hk/eng/home.htm>
- 8.3 Chapter 571 Securities and Futures Ordinance, BLIS
- 8.4 PN820, HKICPA
- 8.5 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, SFC
- 8.6 Licensing Information Booklet, SFC
- 8.7 Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission, SFC
- 8.8 Prevention of Money Laundering and Terrorist Financing Guidance Note, SFC
- 8.9 Legal Bulletin – Requirements on Anti-Money Laundering, Anti-Terrorist Financing and Related Matters, HKICPA
- 8.10 Audit Issues – Audit of Licensed Corporations and Associated Entities of Intermediaries – Q & A, HKICPA

End