

MEMBERS' HANDBOOK

Update No. 182

(Issued 11 March 2016)

Document Reference and Title	Instructions	Explanations
VOLUME III		
Contents of Volume III	Discard the existing pages i, v and replace with the revised pages i, v.	Revised contents page
PRACTICE NOTES		
PN 820 (Revised) <i>The Audit of Licensed Corporations and Associated Entities of Intermediaries</i>	Replace pages 1-2, 16, 18, 24, 28, 40 and 42-65 with revised pages 1-2, 16, 18, 24, 28, 40 and 42-68.	Notes 1 - 2

Note:

- The Auditing and Assurance Standards Committee has embarked on a project to update the relevant auditing and assurance pronouncements for HKSAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, which is effective for assurance reports dated on or after 15 December 2015. PN 820 (Revised) is updated for matters related to HKSAE 3000 (Revised) as well as other industry related matters.

In order for readers to easily identify all the changes, a marked-up version of the above revised pronouncement is posted at:

http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/handbook/trackstds182.pdf

- The key revisions to PN 820 (Revised) are:
 - Amended the reference of "HKSAE 3000" to "HKSAE 3000 (Revised)";
 - Inserted a section of "Our Independence and Quality Control" in all example reports prepared under HKSAE 3000 (Revised);
 - Amended the format of the example assurance reports to align more closely with the requirements of HKSAE 3000 (Revised);
 - Inserted HKSAE 3000 (Revised) guidance for modified opinion / conclusion where appropriate;
 - Inserted additional guidance relating to licensed corporations not permitted to hold client assets; and
 - Inserted additional guidance to consider performing external confirmations (including clients with zero account balances or assets holding if appropriate).



MEMBERS' HANDBOOK
CONTENTS OF VOLUME III

(Updated to March 2016)

		<i>Issue/Review date</i>	
Preface (Amended)	Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance and Related Services Prouncements	07/12	
Glossary (Clarified)	Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services	02/15	
HONG KONG STANDARDS ON QUALITY CONTROL			
HKSQC 1 (Clarified)	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements	02/15	
HONG KONG FRAMEWORK FOR ASSURANCE ENGAGEMENTS			03/14
Framework	Hong Kong Framework for Assurance Engagements	03/14	
Framework (Amended)	Hong Kong Framework for Assurance Engagements	03/14	
HONG KONG STANDARDS ON AUDITING			
HKSA 200 – 299	GENERAL PRINCIPLES AND RESPONSIBILITIES		
HKSA 200 (Clarified)	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing	02/15	
HKSA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing	01/16	
HKSA 210 (Clarified)	Agreeing The Terms of Audit Engagements	06/14	
HKSA 210	Agreeing the Terms of Audit Engagements	01/16	
HKSA 220 (Clarified)	Quality Control for an Audit of Financial Statements	02/15	
HKSA 220	Quality Control for an Audit of Financial Statements	08/15	
HKSA 230 (Clarified)	Audit Documentation	02/15	
HKSA 230	Audit Documentation	08/15	
HKSA 240 (Clarified)	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	02/15	
HKSA 240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	01/16	
HKSA 250 (Clarified)	Consideration of Laws and Regulations in an Audit of Financial Statements	07/10	
HKSA 260 (Clarified)	Communication with Those Charged with Governance	02/15	
HKSA 260 (Revised)	Communication with Those Charged with Governance	01/16	
HKSA 265 (Clarified)	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	02/15	

		<i>Issue/Review date</i>
PN 820 (Revised)	<u>The Audit of Licensed Corporations and Associated Entities of Intermediaries</u>	03/16
PN 830 (Revised)	<u>Reports by the Auditor Under the Banking Ordinance</u>	12/14
PN 840	<u>The audit of solicitors' accounts under the Solicitors' Accounts Rules and the Accountant's Report Rules</u>	09/04
PN 850	<u>Reporting on Flag Days and General Charitable Fund-raising Activities Covered by Public Subscription Permits issued by the Social Welfare Department</u>	12/15
PN 851	<u>Review of the Annual Financial Reports of Non-governmental Organisations</u>	09/04
PN 852	<u>Review of lottery accounts</u>	09/15
PN 860.1 (Revised)	<u>The Audit of Retirement Schemes</u>	12/15
PN 870	<u>The assessments of Certification Authorities under the Electronic Transactions Ordinance</u>	09/04
PN 871	<u>Engagement to report on compliance with the Billing and Metering Integrity Scheme of OFTA</u>	09/04
PN 900 (Revised)	<u>Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</u>	09/14
 AUDITING GUIDELINES		
AG 3.283	<u>Guidance for internal auditors</u>	09/04
AG 3.340	<u>Prospectuses and the reporting accountant</u>	04/14
 HONG KONG AUDITING PRACTICE GUIDANCE		
HKAPG 1000	<u>Special Considerations in Auditing Financial Instruments</u>	12/12

PN 820 (Revised)
Issued December 2014; revised March 2016

Effective upon issuance

Practice Note 820 (Revised)

The Audit 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 (REVISED)
THE AUDIT OF LICENSED CORPORATIONS AND
ASSOCIATED ENTITIES OF INTERMEDIARIES**

*(Issued December 2014; Revised March 2016
Effective upon issuance)*

<i>Contents</i>	<i>Paragraphs</i>
<u>PART I – GENERAL</u>	
Introduction	1 - 7
Definitions	8
Legislation and regulatory requirements	9 - 27
<u>PART II - THE AUDIT OF FINANCIAL STATEMENTS</u>	
Introduction	28
HKSAs	29 - 70
<u>PART III - AUDITOR'S REPORTS UNDER THE SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES</u>	
Introduction	71
Management's responsibilities	72 - 75
Auditor's responsibilities	76 - 79
General guidance for fulfilling auditor's responsibilities	80- 83
Auditor's reporting requirements	84 - 89
Guidance on the reporting requirements of the Compliance Report	90 – 114
<u>PART IV - OTHER REPORTING CONSIDERATIONS</u>	
Audit Questionnaire	115 - 117
Account Disclosure Document	118
Cessation of Activities	119 - 120
<u>PART V - COMMUNICATIONS BETWEEN THE AUDITOR AND THE SECURITIES AND FUTURES COMMISSION</u>	
Introduction	121 - 125
The auditor to lodge report with the SFC in certain cases	126 - 135
Other communications by the auditor	136 - 158

56. Client assets is one area where detailed internal controls are particularly relevant. 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 107 to 110). Any shortfall in client assets, whether due to misappropriation or otherwise, may have significant implications on the regulated entity'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 regulated entity. 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 regulated entity's system of control over client assets or system of control to avoid receiving or holding client assets for a regulated entity which does not hold client assets are inadequate or decides that no reliance would be placed on the regulated entity's systems, the auditor would use its professional judgment to consider the use of fund tracing procedures or external circularisation as a substantive procedure to obtain evidence on some of the control objectives, e.g. paragraphs 45, 47, 68 and 69 of Appendix 2 to this Practice Note. Fund tracing means obtaining copies of sampled outward cheques issued by the regulated entity from the bank or copies of cheques deposited into the bank account of the regulated entity and verifying the identity of the payee or drawer against the regulated entity's accounting records.
57. 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 consequential need for an increased level of control from outside the branch are relevant to audit planning.
58. 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.
59. 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: MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

Background note

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. (HKSA 320 paragraph 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 paragraph 11)

For purposes of the HKSAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements 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 levels for particular classes of transactions, account balances or disclosures. (HKSA 320 paragraph 9)

HKSA 505: EXTERNAL CONFIRMATIONS

Background note

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 paragraph 16)

63. External confirmation of client account balances can provide strong evidence regarding the existence of the account and accuracy of the regulated entity's records of client assets held at a certain date. It can also provide strong audit evidence regarding the operation of cut-off procedures.
64. 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. Given the objectives of the external confirmations as noted in paragraph 63 above, the auditor should consider to circularize external confirmations (including clients with zero account balances or assets holding if appropriate). Further details on circularisation are set out in paragraph 27 of Appendix 2 to this Practice Note.
65. 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.

HKSA 560: SUBSEQUENT EVENTS

Background note

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 paragraph 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 paragraph 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 report 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 paragraph 10)

The auditor's report on the financial statements

85. For a regulated entity which is a Hong Kong incorporated company, the auditor's report contains a true and fair audit opinion 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.
86. 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 90 to 101 below.

Compliance report by the auditor

87. The compliance report setting out the auditor's conclusions on matters set out in paragraph 79 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

88. The auditor would state that the compliance reporting engagement has been conducted in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised), *Assurance Engagements Other Audits or Reviews of Historical Financial Information* issued by the HKICPA, and with reference to this Practice Note. It also provides an informative summary of the work performed as the basis for the auditor's conclusion.

The date of the report

89. 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

90. 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.
91. 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 financial year 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.

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

107. There are essentially two aspects to the auditor's reporting responsibilities for client assets:
- a. whether during the financial year 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 financial year under review, the regulated entity complied with the relevant sections of the client asset rules.
108. 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.
109. 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.
110. 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 41 and 42 of this Practice Note.

Qualified Compliance Reports

111. 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 compliance report.
112. 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.
113. If the auditor proposes to include any qualification or adverse statement in the compliance report (or its report on the financial statements), the form and content of the report should comply with the requirements of HKSAE 3000 (Revised). Section 157(1)(b) of the SFO, requires the auditor, 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.

APPENDIX 1 - EXAMPLES OF AUDITOR'S REPORTS

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

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF ABC SECURITIES LIMITED

(incorporated in Hong Kong with limited liability)¹

Report on the Financial Statements

We have audited the financial statements of ABC Securities Limited ("the Company") set out on pages to..... , which comprise the statement of financial position as at 31 December 20X1,² and [the statement of profit or loss and] ³ the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. 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 audit⁴. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to Practice Note 820 (Revised), *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 about 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 of financial statements that give a true and fair view in order to design audit procedures

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

² For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities.

³ HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

⁴ The 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".

Example 2 - compliance report by the auditor - licensed corporation

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON COMPLIANCE WITH THE HONG KONG SECURITIES AND FUTURES ORDINANCE

To the Board of Directors of ABC Securities Limited ("the Company")

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 report for the year ended [*year end date*] for submission by the Company to the Hong Kong Securities and Futures Commission ("SFC").

Directors' Responsibilities

In relation to this 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.[#] 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.[#] sections 4, 5, 6, 8(4), 10 and 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
- d. the Company has complied with the Hong Kong Securities and Futures (Financial Resources) Rules.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1¹ and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

¹ HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

Auditor's Responsibilities

Our responsibility is to express an independent conclusion on the Company's compliance with the relevant sections of the Hong Kong Securities and Futures (Accounts and Audit) Rules, the Hong Kong Securities and Futures (Client Money) Rules, the Hong Kong Securities and Futures (Client Securities) Rules and the Hong Kong Securities and Futures (Keeping of Records) Rules as described in the directors' responsibilities section above, based on our engagement, and to report our conclusion to you.

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 820 (Revised), *The Audit of Licensed Corporations and Associated Entities of Intermediaries* issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving conclusions 1(a) to (c) and obtain limited assurance for giving conclusion 2 below.

In relation to our conclusions 1(a) and 1(c) below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 820 (Revised), which included examining, on a test basis, evidence obtained from the Company regarding the Company's compliance with the above sections of the Hong Kong Securities and Futures (Accounts and Audit) Rules, the Hong Kong Securities and Futures (Client Money) Rules, the Hong Kong Securities and Futures (Client Securities) Rules and the Hong Kong Securities and Futures (Keeping of Records) Rules.

[In relation to our conclusion 1(b) below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in the document "Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.][#]

In relation to our conclusion 2 below, we are not required to perform any procedures to search for instances of contravention of the Hong Kong Securities and Futures (Financial Resources) Rules. Our work was limited to reporting contraventions identified during the normal course of our work.

The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

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*²

Based on the foregoing:

1. in our opinion:

² In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised). Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).

- 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.[#] 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.[#] sections 4, 5, 6, 8(4), 10 and 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
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.

Intended Users and Purpose

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]
[Auditor's Address]
[Date]

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

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.]

^{*}: *For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the cessation date of the licensed corporation's regulated activities. In addition, the reference to "section 3(1)(b)" of the Hong Kong Securities and Futures (Accounts and Audit) Rules in this example report should be changed to "section 3(2)(b)" instead.*

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

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON COMPLIANCE WITH THE HONG KONG SECURITIES AND FUTURES ORDINANCE

To the Board of Directors of ABC Nominee Limited ("the Company")

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 report for the year ended [*year end date*] for submission by the Company to the Hong Kong Securities and Futures Commission ("SFC").

Directors' Responsibilities

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

- a. the Company has systems of control in place that are adequate to ensure compliance with:
 - i.[#] sections 4, 5, 6, 8(4), 10, 11 of the 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.[#] 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.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1¹ and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Auditor's Responsibilities

Our responsibility is to express an independent opinion on the Company's compliance with the relevant sections of the Hong Kong Securities and Futures (Client Money) Rules, the Hong Kong Securities and Futures (Client Securities) Rules and the Hong Kong Securities and Futures (Keeping of Records) Rules as described in the directors' responsibilities section above, based on our engagement, and to report our opinion to you.

¹ HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 820 (Revised), *The Audit of Licensed Corporations and Associated Entities of Intermediaries* issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving our opinion below.

In relation to our opinion (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 Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules" issued by the SFC.

In relation to our opinion (b) below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 820 (Revised), which included examining, on a test basis, evidence obtained from the Company regarding the Company's compliance with the above sections of the Hong Kong Securities and Futures (Client Money) Rules, the Hong Kong Securities and Futures (Client Securities) Rules and the Hong Kong Securities and Futures (Keeping of Records) Rules.

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

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.

*Opinion*²

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.[#] 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. 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.[#] 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.

² In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised). Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).

Intended Users and Purpose

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]
[Auditor's Address]
[Date]

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

*: *For cessation audits (see paragraph 119), reference to the financial year end date in this example report should be changed to the date that the entity ceases to be an associated entity.*

Example 4 – example modified auditor's assurance reports

The following examples of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on Examples 2 and 3 in Appendix 1.

(a) Qualified conclusion for Example 2 – compliance report by the auditor – licensed corporation

...

Basis for Qualified Conclusion

In respect of conclusion 1(c) below, we identified the non-compliance with [insert relevant sections of the relevant rules] as set out in the appendix to this report.

Qualified Conclusion

Based on the foregoing,

1. in our opinion:

...

- c. except for the effect of the matter described in the Basis for Qualified Conclusion section of our report, 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. 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.

...

(b) Qualified opinion for Example 3 – compliance report by the auditor – associated entity of intermediary

...

Auditor's Responsibilities

...

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

Basis for Qualified Opinion

In respect of opinion (b) below, we identified the non-compliance with [insert relevant sections of the relevant rules] as set out in the appendix to this report.

Qualified Opinion

Based on the foregoing, in our opinion:

...

- b. except for the effect of the matter described in the Basis for Qualified Opinion section of our report, 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. 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.

...

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. In this regard, the SFC has issued guidance to licensed corporations in the 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. 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 financial year 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 financial year 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 financial year 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 (applicable to securities collateral only) 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 the intermediary or 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. of the custodian 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 or otherwise result in the intermediary, associated entity or a related corporation of the intermediary having the benefit or use of the client securities or securities collateral;
 - 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, the licensed corporation may withdraw client securities from a trust account or client account, or deal with client securities that have been registered in the name of the client or an associated entity, for the purpose of selling the securities or settling 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 licensed or registered for dealing in securities 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 or registered 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 – that exceed 140% of aggregate margin loans are promptly identified and rectification action is taken within the following business day in accordance with the rules; 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 financial year 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 financial year 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 financial year 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. Given the objectives of the external confirmations as noted in paragraph 63 in Part II of this Practice Note, the auditor should consider to circularize external confirmations (including clients with zero account balances or assets holding if appropriate);
 - 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. Further guidance on client asset reconciliation is set out in the 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.

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 and the 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;
 - 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 financial year 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 assets 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 and custodian accounts and client agreements;
 - g. enquire as to details of any client assets the licensed corporation has received and the action taken; and
 - h. review the complaints log for any indication that the licensed corporation has held client assets.

The auditor should be alert to findings from the above procedures which may indicate that the licensed corporation has held client assets. In such circumstances, the auditor should refer to the guidance in paragraph 65 in Part II of this Practice Note and consider to send confirmations to the licensed corporation's clients. In addition, the auditor should refer to the guidance in Part V of this Practice Note and consider to report to the SFC.

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 financial year under review.