Accounting and Financial Reporting Council
會計及財務匯報局

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Checkpoint –

Reminders for Auditors' Reporting on Licensed Corporations

Inspection

28 March 2025

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Section 1
Foreword

Licensed Corporations in Hong Kong

Currently, over 3,300 entities licensed under the Securities and Futures Ordinance (**SFO**) are licensed corporations (**LCs**), which include brokers, investment advisers, fund managers, and intermediaries. Securities dealers and securities margin financiers represent a substantial portion of the LCs, which collectively manage client money of HK$405 billion and generate annual net commission income of HK$20 billion. This underscores their significance in the Hong Kong capital market and the public interest they serve.

Auditors’ reporting responsibilities

Auditors play a critical role in ensuring LCs provide accurate and reliable financial statements and correctly compile the required returns for submission to the Securities and Futures Commission (**SFC**). Auditors typically refer to Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries* (**PN820**) when planning the audit approach of the financial statements of LCs and their other reporting responsibilities under the SFO, as set out in the Securities and Futures (Accounts and Audit) Rules.

Despite 2024 being the third year in which LC audit and assurance engagements were inspected, we continue to find recurring and unacceptable findings, indicating significant room for quality improvement. Auditors must double down on efforts to enhance their understanding of their reporting responsibilities under the SFO and the application of PN820 in their LC engagements.

Our expectations

This publication provides an overview of our key 2024 inspection findings relating to LC audits and assurance engagements. By understanding the nature of these inspection findings, auditors can learn from others and use this knowledge to their advantage when finalising their LC audit and assurance work for the upcoming reporting. To help the profession uphold audit quality and diligently fulfil their other reporting responsibilities under the SFO, Annexes A and B provide guidance on how auditors can effectively address these findings.

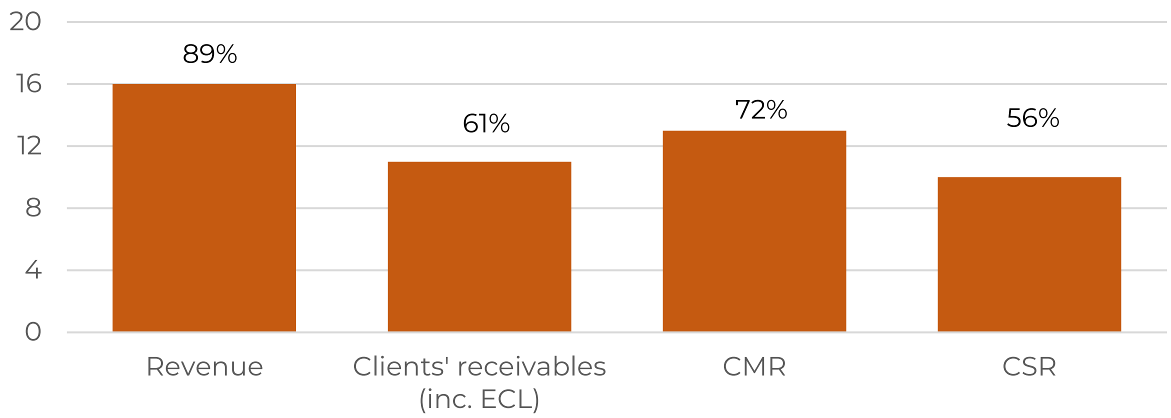
Section 2
Overview of the 2024 Inspection

Key considerations for LC engagements

Given the business nature of LCs, our inspections of financial statement audits typically focus on key financial statements line items most relevant to their operations, such as revenue, clients' receivables, and related expected credit losses (**ECL**) allowance.

When inspecting an auditor's assurance work on a LC's compliance with the SFO, our inspectors typically focus on procedures performed by the auditor to address potential risks associated with the protection of clients' money and securities, as well as other critical requirements imposed on the LCs, such as the maintenance of adequate liquid capital.

Most frequently inspected audit/assurance areas



Note: Percentages indicate the number of areas inspected relative to the total number of LCs engagements inspected

Inspection results

We have inspected 18 LC audit and related assurance engagements in our 2024 inspections. Our inspections of these engagements revealed significant findings in both audit and assurance work performed by the auditors. The most prevalent audit deficiencies were related to insufficient testing over brokerage income and insufficient evaluation of the adequacy of the loss allowance for ECL on clients' receivables. In assurance engagements, our inspections continued to uncover significant findings in auditors' work in assessing LCs' compliance with the Securities and Futures (Client Money) Rules (**CMR**) and the Securities and Futures (Client Securities) Rules (**CSR**).

Section 3
Common Findings – Audit

Revenue is typically a material account to LCs with a presumed risk of fraud. Auditors should understand the controls management designed, implemented, and maintained to prevent and detect fraud. They should also design and perform audit procedures that tailor the nature, timing, and extent to address the assessed risk at the assertion level.

Insufficient understanding of the LCs' use of information technology in information systems

It is common for LCs to use information technology (**IT**) in their information systems. LCs typically deploy IT to receive, place and settle clients' trade and other orders, keep records and issue trade documents, monitor cash flow and perform reconciliation, etc. Nonetheless, some auditors did not sufficiently or even fail to understand how their LC clients use IT in their information systems. This includes understanding the brokerage and accounting systems and considering their impact on audits and compliance reporting. Specifically, they did not understand or sufficiently understand:

- How a trade order is handled and processed through information systems after the LC receives a trade order from the client.
- How the brokerage income is calculated, recorded, and reported in the financial statements based on information flow in information systems.
- Whether information systems of their LC clients are linked to third-party systems.

Without first obtaining a sufficient understanding of their LC clients' use of IT in information systems and related controls, as well as assessing their impact on audits, auditors cannot support their conclusion that revenue, brokerage income in particular as it is usually significant, is not materially misstated simply by performing substantive testing of a sample of revenue transactions.

Common Findings – Audit (continued)

Insufficient testing over brokerage commission

Brokerage income typically accounts for a material portion of a LC's revenue. To test the accuracy of brokerage income, some auditors recalculated the brokerage income for a selection of securities buy/sell transactions and compared them to the ledger amounts.

Brokerage income = Value of transactions executed x ***brokerage commission***

While these auditors have verified the value of transactions executed by checking to the Central Clearing and Settlement System (**CCASS**) statements, they relied solely on the brokerage commission recorded in the LCs' brokerage systems without verifying their accuracy, for example, by agreeing to the brokerage commission in the client agreements. Without ensuring the accuracy of the brokerage commission, the auditors did not obtain sufficient evidence on the accuracy of the brokerage income, even if they found it to be mathematically accurate.

The reliability of monthly client statements as audit evidence was not evaluated

Some other auditors chose to test the accuracy of brokerage income by selecting a sample of transactions from the revenue ledger and verifying them to the monthly client statements issued by the LCs. However, they did not test the **reliability** of these statements before using them as audit evidence. Auditors are reminded that, according to paragraph 9 of HKSA 500 *Audit Evidence*, they are required to obtain evidence about the accuracy and completeness of the information produced by their audit clients, including the monthly client statements in question, before using such information for audit purposes.

Common Findings – Audit (continued)

LCs typically record loss allowance for ECL for accounts receivables (**AR**) related to **margin clients**, whose estimation often involves **significant management judgements** and **estimates**. Auditors should evaluate whether the data on which the estimates are based are accurate, complete, and relevant.

Insufficient evaluation of the significant assumptions used in the ECL estimation

LCs typically adopt a simplified approach under HKFRS 9 *Financial Instruments* to measure loss allowance for ECL for AR. However, some auditors **did not perform sufficient audit procedures** to test the **appropriateness** of **significant assumptions** adopted by the management in estimating the loss allowance for ECL. Specifically, they did not evaluate whether:

- The grouping of margin clients was appropriate based on their credit risk characteristics for determining the probability of default.
- The haircuts applied to collaterals placed by margin clients were reasonable and supportable.

Insufficient testing over the reliability of information used in the ECL estimation

To evaluate whether the loss allowance for ECL is appropriate, auditors must first ascertain the existence and accuracy of gross AR balances at the end of the reporting period.

Similar to revenue testing, some auditors inspected monthly client statements to verify the existence and accuracy of gross AR balances and relied on the AR ageing report provided by the management to recompute the loss allowance for ECL. However, they did not test the reliability of such information before relying on it as audit evidence.

No alternative procedures for non-responses to confirmation requests

Auditors typically use external confirmations to ascertain the existence, accuracy, valuation and allocation of gross AR balances at the end of the reporting period. However, some did not perform alternative audit procedures for those confirmation requests that received no responses, particularly those related to retail clients of the LCs.

Common Findings – Assurance

Insufficient understanding of the LCs' **internal controls**

CMR s.10 & CSR s.5

Auditors did not obtain a sufficient understanding of the LCs' internal controls related to **dealing with client money and client securities**. Specifically, auditors did not obtain an understanding of how LCs' controls were designed to ensure:

- **Money other than client money was identified and paid out of segregated accounts** within one business day of becoming so aware.
- Client securities received by the LCs are **registered in the clients' names or an associated entity** of the LCs.

Obtaining a sufficient understanding of these matters is critical for designing appropriate procedures to evaluate whether the LCs have adequate systems of control in place to ensure compliance with relevant regulatory requirements.

Inappropriate control testing procedures

CSR s.5 & 10(1)

Some auditors examined the signoffs of the reviewers and approvers to conclude that the LCs' controls related to client securities reconciliations were operating effectively. Nevertheless, a review of reconciliation is a management review control and is usually the last line of defence to identify discrepancies or errors in the financial or compliance reporting process. Given their significance, auditors should independently reperform the reconciliations and compare their results with those of the management or observe how the preparer prepared the reconciliations and how the reviewers performed the reviews. Both procedures would require the auditors to understand how these control owners identify and resolve issues before concluding that they are effective. It should be noted that examining the signatures on the reconciliations is not sufficient to arrive at that conclusion.

Inadequate testing over **reliability of IPE**

CMR/CSR

Like audit engagements, auditors did not **test the reliability** of IPEs, e.g., a listing on client money/securities and daily stock reconciliation reports, before using them for sampling or as evidence in the assurance testing.

Common Findings – Assurance (continued)

Inappropriate determination of **testing population**

CMR s.5

Some auditors did not appropriately identify the population from which samples were drawn to test controls over the payment of client money out of segregated accounts. Specifically, they only selected and tested client money paid following written direction from clients, without testing other types of **client payments out of segregated accounts,** e.g., client money paid in accordance with a standing authority.

CSR s.5

Some auditors did not appropriately consider the **characteristics of different populations** when designing testing procedures. Specifically, they combined deposits and withdrawals of client securities into a single population for testing without considering the differences in the transaction nature and the related control activities.

Determination of **sample size** is based on **incorrectly identified control frequency**

CMR/CSR

Some auditors did not appropriately consider the **frequency** of control occurrences when determining the sample size for testing. For instance, control activities over brokerage transactions that occurred multiple times in a trading day were incorrectly treated as a daily control rather than "multiple times per day".

Furthermore, some auditors did not ensure that each item in the population had an equal chance of being chosen when they randomly selected items from the population being tested. For example, to test LCs' compliance with section 5 of the CMR, some auditors only selected a sample of payment transactions in a particular month rather than throughout the financial year.

Section 4
Good Practices

During our inspection, the following good practices that contribute to the delivery of high-quality audits were observed in firms engaging in LC engagements.

Critical assessment of technical ability and capability in servicing LCs before client and engagement acceptance and continuance

A robust client acceptance and continuance procedure enables audit firms to identify elevated audit risks through a critical assessment of their technical capability, resource capacity, and overall preparedness. This is particularly important given that industry knowledge is required for the performance of quality audit and assurance engagements for LCs.

Only individuals with appropriate competence and capabilities are assigned as engagement team members

Audit firms only assign individuals with industry knowledge and experience in servicing LCs as engagement team members. This enables engagement teams to fully understand their LC clients' business operations, financial reporting processes, and the use of information systems. This understanding is crucial for designing and performing sufficient and appropriate procedures to ensure performance of quality audits and compliance with professional standards and regulatory requirements.

Effective use of standardised templates with practical guidance

Audit firms develop standardised templates for audit procedures in key audit areas of LCs, such as brokerage income and ECL of clients' receivables. They also develop an assurance programme that includes guidance notes and practical examples to support the consistent performance of testing procedures related to LCs' compliance with the CMR and the CSR.

Commitment on Continuing professional development

Committed and invested in people — Audit firms provide sufficient internal or external training relevant to the audit and assurance engagements of LCs. This training equips engagement team members with industry-specific knowledge and expertise that supports talent development and upholds audit and assurance quality.

Keep up with changes in regulations and professional standards

Audit firms provide timely audit alerts on changes in regulations and professional standards, ensuring that engagement teams are informed of the latest industry developments and can effectively assess the impacts of these changes on their audit and assurance engagements.

Timely and robust monitoring and remediation

Audit firms inspect a sample of completed LC audit and assurance engagements as part of their annual monitoring activities. Where inspection findings related to these engagements are identified, audit firms act promptly by performing root-cause analyses and remediation to prevent them from recurring.

Section 5
Emerging Risks and Opportunities

The rapidly evolving business landscape of LCs presents both challenges and opportunities for auditors. By embracing these changes, auditors can effectively manage risks and capitalise on new opportunities to add value, drive growth, and enhance their professional relevance.

5.1 Virtual asset development

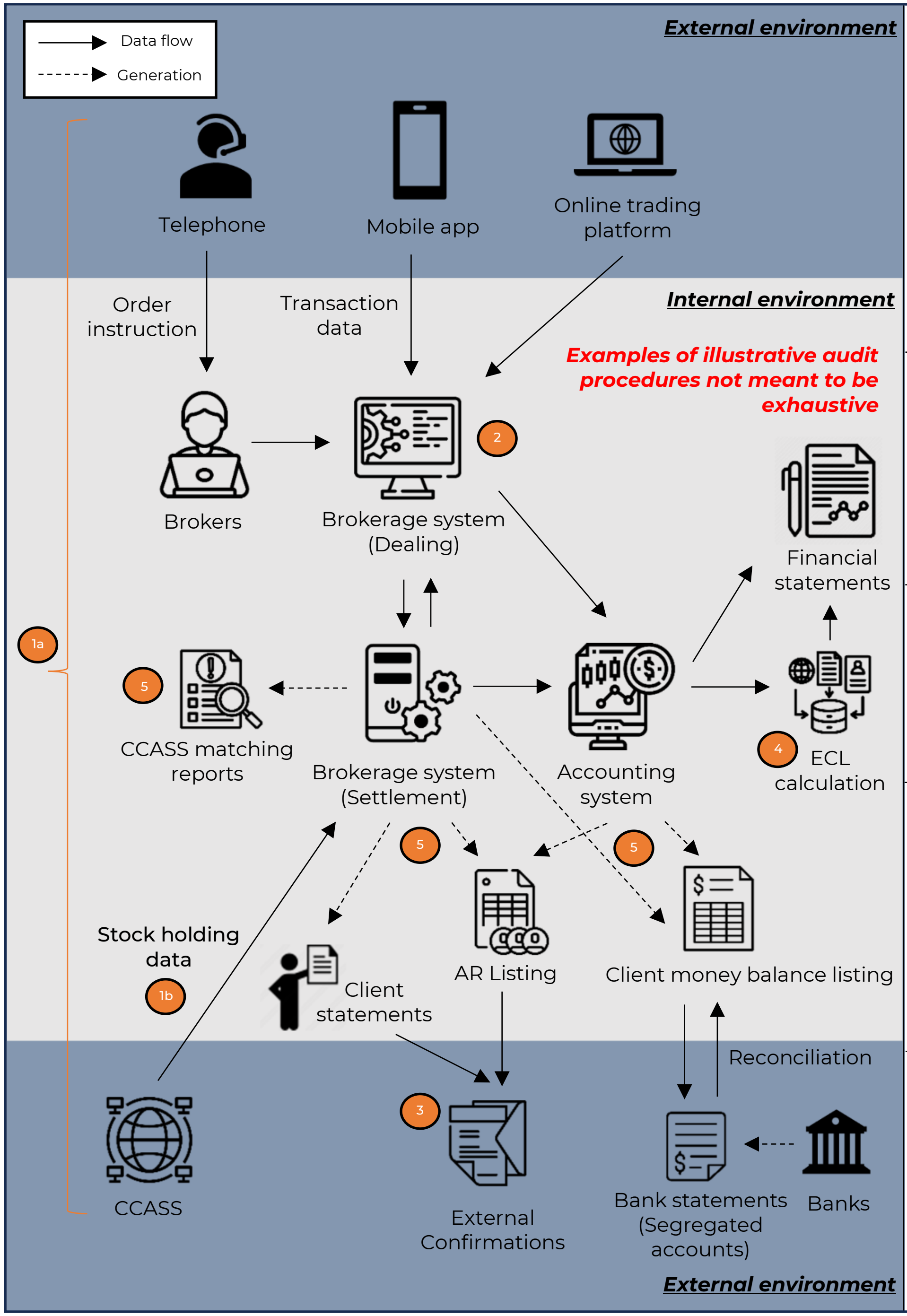
Hong Kong has introduced a new virtual asset trading platform (**VATP**) licensing regime and a stablecoin regulatory regime to accelerate the development of virtual assets (**VA**) and establish the city as a leading VA hub in Asia. These initiatives aim to enhance the VA regulatory environment, improve infrastructure, and foster the growth of the Web3 ecosystem. As of March 2024, there are 10 licensed VATPs, with more expected to follow.

5.2 Family offices development and SFC new regulated activity

The Hong Kong SAR Government has been actively promoting Hong Kong as a leading hub for family offices, attracting high-net-worth individuals and families to set up operations or expand their businesses. This has led to an increase in family trusts and a growing demand for asset management services. Furthermore, the SFC implemented the new Type 13 regulated activity regime in late 2024, which includes enhancements to the compliance requirements for depositaries of SFC-authorised collective investment schemes in Hong Kong. This has also led to an increased number of LCs in the asset and wealth management business.

Annex A – Examples of illustrative audit procedures

Examples of illustrative audit procedures not meant to be exhaustive



Understand the information flow of revenue transactions

1a Perform a walkthrough to obtain an understanding of the information flow of revenue transactions, including how transactions are initiated, recorded, processed, and reported in the financial statements. This should also include how internal records are reconciled with external records.

1b Understand how information systems are used in business processes, for example, how the brokerage system collects external records and reconciles them with internal records (e.g., stock holding data).

Accuracy of brokerage income

2 Obtain an understanding of how brokerage income is calculated and the sources of inputs, specifically the brokerage commission. Perform independent re-computation with sufficient testing on the accuracy and completeness of inputs.

External confirmation requests

3 Perform appropriate alternative audit procedures for confirmation requests that receive no response. For example, examine subsequent settlement records to verify the accuracy and existence of the outstanding balance.

ECL estimation

4 Evaluate the appropriateness of the significant assumptions used by management in estimating loss allowance for ECL. Specifically, evaluate whether the grouping of clients is based on shared credit risk characteristics, and whether the haircuts applied to collateral are justified by assessing the timing and discounts involved in AR recovery.

Reliance of information produced by the entity (IPE)

5 Evaluate the reliability of IPE before using it as audit evidence. For example, ensuring that the transaction details on the monthly client statements agree to the corresponding records in the brokerage system (provided that the general IT controls over the brokerage system and the accuracy and completeness of its data have been tested).

Annex B – Examples of illustrative assurance procedures

Examples of illustrative assurance procedures not meant to be exhaustive

Obtain a sufficient understanding of LCs' Internal Controls Corresponding to Regulatory Requirements

Whether Relevant Internal Controls are Implemented by LCs

Obtain an understanding over the internal control of the identification of money other than client money in segregated accounts and ensures such money is paid out of the segregated accounts within one business day of becoming so aware. (CMR s.10)

Obtain an understanding over the internal control in ensuring client securities received by LC are registered in the name of the client or an associated entity of the LC. (CSR s.5)

Design of control testing

Whether Control Testing Procedures Performed are Appropriately Designed

Evaluate whether the system of control over the identification of unreconciling items in stock reconciliation is operating effectively. (CSR s.5 & 10(1))

Evaluate the follow-up actions of LCs over unreconciling items in client securities reconciliation, including their evaluation of the nature, cause, and resolution of these items. (CSR s.5 & 10(1))

Population & IPE

Whether appropriate Population has been determined. Whether reliability of IPE is evaluated

All client money payments out of segregated accounts should be included in the population. (CMR s.5)

Design appropriate testing procedures to account for the differences in characteristics between deposits and withdrawals of client securities and collaterals. (CSR s.5)

For all IPE relied upon by auditors (including IPE for sample selection), perform testing to evaluate its completeness and accuracy.

Sampling

Whether appropriate sample size has been determined, considering the desired level of assurance and control frequency?

- Multiple times a day
- Daily
- Weekly
- Quarterly
- Monthly
- Annually

Contacts

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