Basis for Conclusions

The Hong Kong Standard on Auditing for Audits of Financial Statements of Less Complex Entities

Hong Kong Institute of
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Contents

I. Introduction

1. This Basis for Conclusions has been reviewed and approved by the Auditing and Assurance Standards Committee ("AASC") of the Hong Kong Institute of Certified Public Accountants ("HKICPA" or the "Institute"). It is provided for the benefit of stakeholders to gain an understanding of the background to the *Hong Kong Standard on Auditing for Audits of Financial Statements of Less Complex Entities* ("HKSA for LCE").

2. This Basis for Conclusions does not form part of the HKSA for LCE and is not a substitute for reading the HKSA for LCE.

II. Background

3. In December 2023, the International Auditing and Assurance Standards Board ("IAASB") issued the *International Standard on Auditing for Audits of Financial Statements of Less Complex Entities* ("ISA for LCE" or the "standard"). It is effective for audits of financial statements of less complex entities ("LCEs") for periods beginning on or after 15 December 2025 with early adoption permitted.

4. Hong Kong has a diverse array of CPA practices, varying in size and range of services they provide.[1] Meanwhile, all companies incorporated under the Companies Ordinance ("CO") in Hong Kong are required to undergo an annual audit of their financial statements by independent auditors. An exemption from this audit requirement is available only to dormant companies.[2]

5. Considering the local circumstances outlined above, in February 2024, the AASC approved in principle the adoption of the ISA for LCE as the HKSA for LCE. The AASC determined that the standard contains all the necessary requirements to provide reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. The appropriate use of the ISA for LCE following the requirements and essential explanatory materials ("EEM") of the standard would not result in a lesser audit quality.

6. The Authority of the standard in Part A sets out the intended scope of the ISA for LCE. Limitations for using the ISA for LCE are designated into three categories:

   - Specific classes of entities for which the use of the ISA for LCE is prohibited (i.e., specific prohibitions).
     - The classes in paragraph A.1.(a), (b) and (d) of the standard are outright prohibitions and cannot be modified.
     - Legislative or regulatory authorities or relevant local bodies with standard-setting authority can modify each class described in paragraph A.1.(c) of the standard, but a class cannot be removed.

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1 As of January 2025, there were 1,910 CPA firms or corporate practices registered with the Accounting and Financial Reporting Council ("AFRC") in Hong Kong.

2 Question 9, FAQ – Companies Ordinance – Accounts and Audits, Companies Registry of The Government of the Hong Kong Special Administrative Region ("HKSAR Government")

- Qualitative characteristics that describe an LCE, and if not exhibited by an entity would ordinarily preclude the use of the ISA for LCE for the audit of the financial statements of that entity.
    - The ISA for LCE does not provide for local bodies with standard-setting authority to modify or refine the qualitative characteristics specified in the standard.
- Quantitative thresholds to be determined by legislative or regulatory authorities or relevant local bodies with standard-setting authority in each jurisdiction.

In determining the appropriate use of the ISA for LCE, all three categories are to be considered.

7. To ensure the appropriate application of the HKSA for LCE, the AASC proposed modifying its Authority of the HKSA for LCE to better align with the Hong Kong's circumstances. In September 2024, the AASC issued an Exposure Draft *Proposed Hong Kong Standard on Auditing For Audits of Financial Statements of Less Complex Entities* ("ED") for public consultation. The ED set out the AASC's proposal to:

(a) Add or modify the classes of entities prohibited from using the HKSA for LCE under paragraph A.1.(c).

(b) Determine quantitative thresholds described in paragraph A.4. of the ISA for LCE.

The Explanatory Memorandum ("EM") that accompanied the ED provided detailed explanations of the proposed modification.

8. The following table summarizes the AASC's proposal regarding the use of the HKSA for LCE:

Category	AASC Proposals in the ED
Specific prohibition	The AASC proposed to incorporate additional classes of specific prohibited entities into paragraph A.1.(c) as detailed below: • An entity that carries on any banking business and is an authorized institution as defined under the Banking Ordinance. • An entity that carries on any insurance business and is an authorized insurer as defined under the Insurance Ordinance. • An entity that is a licensed corporation ("LCs") under Part V of the Securities and Futures Ordinance ("SFO") to carry on a business in any regulated activity within the meaning of that Ordinance. • An entity that is a public interest entity ("PIE") defined in Part 4A, Chapter A of the HKICPA *Code of Ethics for Professional Accountants* (the "Code").

Quantitative thresholds	In determining the appropriate use of the HKSA for LCE, the AASC proposed that an entity or a group of entities should not exceed any two of the following thresholds: • Annual revenue of HK$200 million • Total assets of HK$200 million at the end of the reporting period • 100 employees The AASC's proposed principles for assessing the quantitative thresholds are outlined below: (a) An entity or group must meet the proposed quantitative thresholds for the two immediately preceding reporting periods in order to be eligible to use the HKSA for LCE in that reporting period (subject to meeting all other conditions), regardless of its size in that period. (b) Newly established entities, or a group of entities whose holding company is a newly established entity, can use the HKSA for LCE in their first financial year if they meet these thresholds. (c) Entities currently using the HKSA for LCE can continue using it until they fail the proposed quantitative thresholds for two consecutive years. They will lose eligibility in the reporting period after failing to meet the thresholds for the two immediately preceding financial years. (d) However, a group will lose its eligibility to use the HKSA for LCE immediately if a new entity joins and causes the group to exceed the quantitative thresholds in that financial year. This loss of eligibility occurs without the two-year grace period mentioned in (c) above.

9. The AASC invited comments on all matters in the ED, with particular emphasis on areas highlighted in the Request for Specific Comments section in the EM which can be found in Annex 1. Other initiatives to promote and solicit comments to the ED included:

   - Conducting roundtable discussions with regulators, stakeholders and the Institute's Small and Medium Practices Committee ("SMPC") to promote the HKSA for LCE and explain the AASC proposals in the ED for feedback.
   - An online survey was launched between 14 October and 17 November 2024 to gather comments on the ED.

10. The comment period for the ED ended on 17 November 2024. The AASC received seven comment letters in response to the ED. A few respondents submitted their comments via the online survey. In general, respondents expressed support for the AASC's proposal to modify the application of the HKSA for LCE within a Hong Kong context. Some provided feedback to the specific intricacies of the proposed local refinements.

III. Key Changes Post the ED

11. After deliberations, the AASC decided to retain the proposals in the ED with the following revisions:

Category	Post ED Changes
Specific prohibition	In addition to including the four proposed local entity categories, expand the scope of the specific prohibition to include **an entity that is granted an insurance broker company license under section 64ZA of the Insurance Ordinance to carry on regulated activities in one or more lines of business, and to perform the act of negotiating or arranging an insurance contract as an agent of any policy holder or potential policy holder.**
Quantitative thresholds	Regarding proposed paragraph A.4-5, which invalidates a group's continued use of the HKSA for LCE if a new entity enters the group and causes it to exceed the quantitative thresholds in that financial year, revise the requirement to include both the addition of a new entity and a **business unit**: *However, a group that meets the criteria of using the HKSA for LCE and has been using it in its audit of financial statements will lose the eligibility to use it in the financial year when a new entity or a business unit enters the group and causes the group to exceed the quantitative thresholds in paragraph A.4-1. in that year. The group will lose its eligibility to use the HKSA for LCE immediately in its audit of financial statements in the financial year that the new entity or business unit enters the group, without the two-year grace period in paragraph A.4-4.*

12. Below is a summary of the respondents' comments and how the AASC evaluated and addressed their concerns.

IV. Specific Prohibition in the HKSA for LCE

13. As explained in the ISA for LCE, entities that have public interest characteristics could embody a level of complexity in fact or appearance and are specifically prohibited from using the ISA for LCE.[3]

14. In the ED, the AASC considered that entities with public interest characteristics, for which the use of the HKSA for LCE in their audit engagements might not be appropriate, can be classified into two categories:
- PIEs defined in Chapter A of the Code; and
- Entities that are prohibited from applying the reporting exemption in Part 9 of the CO.

[3] ISA for LCE, EEM to paragraph A.2.

PIEs Defined in the HKICPA Code

15. In the ED, the AASC proposed that entities that are PIE in the Code be prohibited from applying the HKSA for LCE in their audits.

Respondents' Comments to the ED and AASC Decisions

16. In general, respondents supported the AASC's proposal to prohibit entities that are PIEs in Chapter A of the Code from applying the HKSA for LCE in their audits. However, a minority of respondents concerned that future local amendments to the PIE definition may include charitable organizations and LCs under section 116 of the SFO, which, in their view, should not be prohibited from applying the HKSA for LCE in their audit engagements.

17. As explained in paragraph 17 of the EM, the IAASB aligned the classes of specific prohibited entities in the ISA for LCE with the PIE classes in the IESBA's PIE Provisions. Notwithstanding that they serve a different purpose, the IAASB acknowledged that regardless of the purpose, having differing descriptions may cause confusion, and therefore noted the importance of alignment to the greatest extent possible between the Authority of the ISA for LCE and the IESBA Code.[4]

18. In line with the IAASB's decision to align the categories of specific prohibited entities in the Authority of the ISA for LCE with the PIE definition in the IESBA Code, the AASC decided that the specific prohibited entities in the Authority of the HKSA for LCE be aligned with the PIE definition in Chapter A of the HKICPA Code, including any future local amendments made to the PIE definition in Chapter A of the HKICPA Code that may arise over time.

19. The AASC noted respondents' concerns about the uncertainty of the future definition of a PIE in Chapter A of the Code. However, the AASC acknowledged that the Institute's Ethics Committee has implemented a thorough and comprehensive approach to ensure that any local modifications to the PIE definition in the Code is the result of a rigorous due process to include entities whose financial conditions are of a significant public interest in a Hong Kong context. This process involves in-depth research, extensive consultation and thoughtful deliberation, which includes:

    - Engaging in discussions with regulators and relevant stakeholders to consider their feedback.
    - Conducting a public consultation that invites all interested parties to share their views.
    - Categorizing a specific subset of a category as PIE or using size thresholds to distinguish those with significant public interest in the Hong Kong context.

20. The AASC therefore concluded that maintaining alignment with the PIE definition in Chapter A of the Code is crucial to follow the IAASB's alignment decision (paragraph 17)

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4 IAASB Basis for Conclusions: ISA for LCE, paragraph 46

and to prohibit the inappropriate use of the HKSA for LCE in auditing entities whose financial conditions are of significant public interest.

21. With regard to the AASC's proposal to exclude LCs within the meaning of SFO from applying the HKSA for LCE in their audits, please refer to paragraphs 33 to 37 for further discussion.

V. Entities that are Prohibited from Applying the Reporting Exemption in the CO

22. Under section 359(4) of the CO, companies that carry out certain lines of business are not eligible for reporting exemption,[5] even if they are private companies. Classes of prohibited entities that are not eligible to use the reporting exemption were brought forward from the predecessor CO for public interest or regulatory reasons.

23. After evaluating entities prohibited from utilizing the reporting exemption under the CO, the AASC noted that apart from non-bank entities engaging in the money lending business, other types of reporting exemption prohibited entities exhibited a high level of public interest because they hold assets in a fiduciary capacity for a broad group of stakeholders as one of their primary businesses. Accordingly, the AASC proposed that they should be prohibited from applying the HKSA for LCE in their audits.

Respondents' Comments to the ED and AASC Decisions

Non-bank Money Lenders

24. Most respondents responding to the ED supported the AASC's proposal of not prohibiting non-bank money lenders from applying the HKSA for LCE in their audits. However, one respondent held an opposite view that these entities operate in a landscape with regulatory concerns, such as anti-money laundering ("AML") implications. Moreover, the respondent noted that the application requirement of license for a money lender explicitly indicates that "*….in all the circumstances the grant of such licence is not contrary to the public interest…*". In the respondent's view, not prohibiting non-bank money lenders from applying the HKSA for LCE would introduce inconsistency with section 359(4) of the CO and may mislead the public on relaxation of audit requirements to these entities.

25. Regarding non-bank money lenders, the AASC highlighted in paragraph 30 of the EM that their level of public interest is comparatively restricted. Unlike banks, insurance companies and SFC-authorized corporations, non-bank money lenders neither receive nor manage public deposits or client assets. Furthermore, money lenders have not been included or considered as a potential PIE category during any of the IESBA's deliberations on the definition of a PIE.

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[5] Private entities or groups of private entities meeting the criteria and size tests specified in Part 9 of the CO are eligible for the reporting exemption. They have the option to prepare their financial statements using the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard ("SME-FRS & SME-FRF"), which is the accounting standard to be followed under section 380(4)(b) of the CO by those Hong Kong incorporated companies which are entitled to, and decide to, take advantage of the reporting exemption as set out in section 359 of the CO.

26. In Hong Kong, a person conducting business as a money lender must obtain a money lender's license under the Money Lenders Ordinance ("MLO").[6] Unlike LCs or insurance broker companies where licenses are granted to incorporated companies (either a Hong Kong or non-Hong Kong company),[7] the MLO does not impose a requirement for money lenders to be an incorporated company. Companies, partnerships or individuals can apply for money lender licenses.

27. Furthermore, the AASC observed that money lenders are subject to different levels of regulatory requirements compared to LCs and licensed insurance broker companies. This discrepancy may indicate a lower level of public interest associated with money lending activities than in the latter two industries:

- **Absence of a sector-specific regulator:** Unlike LCs and licensed insurance broker companies which are monitored by the SFC and the Insurance Authority ("IA") respectively through off-site monitoring (such as the review of audited financial statements) and on-site inspections to ensure their compliance with relevant laws and regulations, there is currently no dedicated regulatory body overseeing money lenders. Instead, the Licensing Court, the Registrar of Money Lenders and the Commissioner of Police each assume different roles in the licensing process for money lenders.[8]
- **No mandatory audit requirements:** The MLO does not require money lenders to prepare audited financial statements or obtain periodic auditor's opinion on their compliance with the MLO. In contrast, LCs and licensed insurance broker companies are obligated to meet these requirements under the SFO[9] and Insurance Ordnance[10] respectively.
- **Financial resources:** LCs are subject to minimum paid-up capital and liquid capital requirements.[11] Licensed insurance broker companies are subject to prescribed capital, net asset and professional indemnity insurance requirements.[12] However, the MLO does not impose comparable financial resources requirements on money lenders.

28. The AASC considered that the licensing conditions of non-bank money lenders, which require the grant of the licence not contrary to the public interest, in fact, pertains to the regulator's licensing perspective and is indeed a requirement for many regulatory licensees.[13] This does not imply that the activities, services, or financial conditions of non-bank money lenders are of significant public interest.

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[6] Licensing of Money Lenders – Governing Authorities, Companies Registry of the HKSAR Government

[7] Section 64 ZA of the Insurance Ordinance; section 114(2) of the SFO

[8] Licensing of Money Lenders – Governing Authorities, Companies Registry of the HKSAR Government

[9] Section 156 of Securities and Futures (Financial Resources) Rules

[10] Section 8 and 9 of Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules

[11] Section 5 and 6 of Securities and Futures (Financial Resources) Rules

[12] Section 3, 4 and 5 of Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules

[13] For example, under the Dutiable Commodities (Liquor) Regulations, the Liquor Licensing Board shall not grant a liquor licence unless it is satisfied that in all the circumstances the grant of the licence is not contrary to the public interest.

29. The AASC also noted the respondent's comments that money lenders are subject to AML requirements. In Hong Kong, the Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("AMLO") establishes statutory obligations regarding customer due diligence and record-keeping for specified financial institutions and designated non-financial businesses and professions, including trust and company service providers. Consequently, money lenders are just one of the businesses subject to AML requirements. The fact that money lenders are subject to AML requirements alone does not, in itself, imply that they possess significant public interest or complexity, which would warrant their exclusion from applying the HKSA for LCE in their audit engagements.

30. Regarding the respondent's comment that excluding non-bank money lenders would introduce "inconsistency with Section 359(4) of the CO and may mislead the public on relaxation of audit requirements to these entities", the AASC emphasized that:

- It is not the AASC's intention to align the specific prohibition in the HKSA for LCE with entities prohibited from utilizing the CO's reporting exemption. The AASC noted that the CO's reporting exemption criteria were tailored with a focus on Small and Medium Enterprises ("SMEs") and generally reflect the characteristics and sizes of SMEs in Hong Kong. Therefore, the AASC evaluated entities prohibited from utilizing the CO's reporting exemption and examined their eligibility to use the HKSA for LCE in their audits, rather than aligning the two sets of criteria which serve different purposes.
- The objective of the ISA for LCE is to provide the same level of assurance as the International Standard on Auditing ("ISAs"), i.e., reasonable assurance. The IAASB explains that the ISA for LCE does not reduce the quality of the audit or necessarily mean less work. It helps auditors focus on aspects of the audit that are relevant for less complex entities.[14] Therefore, appropriate application of the HKSA for LCE in audit engagements would not result in a "relaxation of audit quality".

31. As mentioned in paragraph 5, the AASC concluded that if the ISA for LCE is appropriately applied to audits of entities falling under its Authority, it contains all the necessary requirements to provide reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. Consequently, it is necessary that the AASC modifies the authority of using the HKSA for LCE to ensure its appropriate use in the Hong Kong circumstance.

32. Considering the factors discussed in paragraphs 25 to 30, the AASC determined that audits of non-bank money lenders should not be restricted from applying the HKSA for LCE, provided that the entity meets all three categories of using the HKSA for LCE (paragraph 6). Should an entity fail to satisfy any of these categories, it would be deemed ineligible to use the HKSA for LCE in its audit engagements.

[14] IAASB Frequently Asked Questions on the ISA for LCE

Corporations Licensed by the SFC

33. The AASC's proposal included prohibiting corporations licensed by the SFC from applying the HKSA for LCE in their audits. However, a few respondents commented that LCs should not be prohibited from applying the HKSA for LCE, although they did not provide any justification for their arguments.

34. Under section 359(4) of the CO, LCs are expressly prohibited from taking advantage of the CO's reporting exemptions in their financial reporting.

35. The following outlines the characteristics of LCs:

- Under the SFO, a corporation that carries on a business in a regulated activity or actively markets services to the public which constitute a regulated activity needs to be licensed. These licensees are known as LCs. According to the SFC Annual Report 2023-2024, the number of LCs in Hong Kong stood at around 3,250.
- In Hong Kong, Schedule 5 of the SFO stipulated 13 types of regulated activity. Broadly, LCs include securities brokers, futures dealers, leveraged forex traders, fund managers, investment advisers, sponsors and credit rating agencies. LCs may hold client assets (including client money) as part of their business activities. This could be for purposes such as settling securities purchases, managing client assets or portfolios, or handling surplus funds for clients. Consequently, LCs may receive or hold client money or securities on behalf of a client during their business operations. However, whether an LC is permitted to hold client assets depends on the specific licensing conditions granted to it.
- LCs typically deposit client securities with the Central Clearing and Settlement System ("CCASS") under the name of the CCASS nominee. This means that investors do not hold the legal title to the shares, although they remain the beneficial owners. Only the client's LC can execute sell orders for these shares, leaving the LC with full control over the client's shares.[15] Furthermore, there have been instances where LCs have mishandled client assets, such as failing to segregate clients' assets from their own accounts.[16] These occurrences, and the custodian arrangement of LCs, suggests that the operations of LCs might exhibit a certain level of public interest and complexity which might not be adequately addressed by the HKSA for LCE in their audit engagements.
- Given the business operations of LCs, such as executing clients' buy or sell orders and facilitating the settlement of client transactions, it is likely that their IT environments are complex. It is therefore reasonable to infer that the IT organizational structure of LCs would exhibit characteristics that are not commonly associated with an LCE, such as having numerous IT systems and applications where information is passed from one IT system/application to another with complicated data interface, as suggested in The ISA for LCE - Authority Supplemental Guidance.

[15] Settlement and custody, Investor and Financial Education Council

[16] See, for example, SFC enforcement news on 22 July 2022 and 21 November 2024

36. The AASC considered the feasibility for distinguishing LCs based on whether they handle significant client money or assets. However, due to the lack of publicly available information regarding the extent of client money or assets held by LCs and considering the diversity of LCs (ranging from Type 1 to Type 13), it is challenging for the AASC to make this distinction and only prohibit a subset of LCs from using the HKSA for LCE in their audit engagements.

37. Given the inherent complexity in LCs' business operations and challenges described above, the AASC maintained its decision to prohibit all LCs from applying the HKSA for LCE in their audits.

Licensed Insurance Broker Companies

38. In Hong Kong, the IA is responsible for supervising insurance intermediaries' compliance with the Insurance Ordinance. This includes the licensing regime of the insurance broker companies. Licensed insurance broker companies give advice on insurance policies to clients and act as agents of clients in the course of dealing with matters relating to insurance policies, including making and settling claims.[17] Consequently, the activities of licensed insurance broker companies are regarded as having public interest due to their fiduciary responsibility in handling client money. For example, they (i) hold insurance premiums, which are subsequently passed on to the insurer; and (ii) receive insurance claim payments on behalf of clients.

39. In the IA's comment letter to the ED, the IA explained that although licensed insurance broker companies are not among the prohibited entities from utilizing the CO's reporting exemption, the IA "does not expect these companies to use simplified reporting".[18] Consequently, when assessing the local application of the HKSA for LCE in audit engagements, the IA considered that licensed insurance broker companies should be treated similarly to entities that are prohibited from the CO's reporting exemption. The IA further explained that licensed insurance broker companies essentially conduct similar activities to those of LCs, particularly LCs licensed for Type 1 (dealing in securities) and Type 2 (dealing in futures securities) regulated activities, which manage client assets and have fiduciary responsibilities to their customers. Therefore, the IA proposed to specifically prohibit licensed insurance broker companies from using the HKSA for LCE in their audit engagements.

40. The AASC acknowledged the IA's view that the activities of licensed insurance broker companies exhibit a certain level of public interest, particularly due to the fiduciary duties these broker companies owe to their clients in managing client money. The AASC also evaluated whether the business activities and industry of licensed insurance broker companies align with the characteristics of an LCE. The assessment indicated that these companies are under stringent regulatory supervision, including but not limited to maintaining prescribed levels of capital, net assets and professional indemnity insurance; the mandatory annual submission of an auditor's report on their financial

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17 Code of Conduct for Licensed Insurance Brokers, IA

18 Under Rule 9(1) of the Broker Rule, the auditor's report on the financial statements of a licensed insurance broker company must provide a true and fair view. However, financial statements prepared by companies eligible for and utilizing the reporting exemption under the CO using SME-FRF & FRS will not present a true and fair view of the financial statements so prepared.

statements, as well as an auditor's report on their compliance with the Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules ("Broker Rules"), to the IA. This aligns with The ISA for LCE - Authority Supplemental Guidance which notes that entities whose performance or financial position being measured against regulatory requirements are typically not an LCE. Although this is one of the many qualitative characteristics, it is noteworthy that broker companies generally operate using a single business model without diversifying into other lines of business.

41. The AASC also noted that the public interest perspective of licensed insurance broker companies comes from the nature of their major business activities, i.e., handling client money in a fiduciary capacity and operating in a highly regulated industry. However, this does not automatically classify them as PIEs in Chapter A of the Code, which primarily focuses on the financial conditions of entities that are of significant public interest.

42. Recognizing that the operations of licensed insurance broker companies are highly regulated and involve fiduciary responsibilities to a diverse clientele including the management of client money, and considering that they are a clearly defined category of entities in Hong Kong, the AASC concluded that at a standard-setter level, licensed insurance broker companies licensed under section 64ZA of the Insurance Ordinance be prohibited from applying the HKSA for LCE in their audit engagements.

VI. Quantitative Thresholds in the HKSA for LCE

Proposed Quantitative Thresholds

43. In determining the appropriate use of the HKSA for LCE, the AASC proposed that an entity or a group of entities should not exceed any two of the following thresholds:

- Annual revenue of HK$200 million
- Total assets of HK$200 million at the end of the reporting period
- 100 employees

44. The ED also proposed basis to determine the number of employees, being the average number of persons employed by the entity or group of entities during the reporting period (irrespective of whether in full-time or part-time employment) determined on a monthly basis as follows:

(i) Determine the number of employees as at the end of each calendar month.

(ii) Add together all the monthly numbers in (i).

(iii) Divide the number in (ii) by the number of months in the reporting period.

Respondents' Comments to the ED and AASC Decisions

45. Most respondents to the ED supported the proposed thresholds in paragraph 43. A few who disagreed raised the following comments:

- The thresholds should be higher, for example, a threshold of HK$300 million in revenue or total assets (compared to the proposed HK$200 million) and 200 employees (instead of the proposed 100).

- The HKSA for LCE should be applicable to all non-PIE entities without any quantitative threshold.
- Setting quantitative thresholds could be too complicated and violate the original intention of the ISA for LCE.

46. Another respondent, who agreed with the proposed thresholds, recommended that the threshold automatically incorporate any future amendments or updates to Schedule 3 of the CO to enhance efficiency in the standard-setting process.

47. As explained in the EM, the AASC made references to the CO's size test for reporting exemption when formulating the proposed quantitative threshold to determine the appropriate use of the HKSA for LCE. This approach was not intended to replicate the size test of the CO's reporting exemption; rather, it provided a basis for the AASC's deliberations. Consequently, entities or groups eligible for the CO's reporting exemption (and therefore eligible to use the SME-FRF & FRS in their financial reporting) would not automatically meet the criteria to use the HKSA for LCE in the audit of their financial statements. To be eligible to use the HKSA for LCE in their audits, an entity or a group must satisfy the layers of requirements, namely specific prohibitions, qualitative characteristics, and the quantitative threshold (paragraph 6).

48. Currently, the size criteria for the reporting exemption under the CO are the only quantitative measures relevant to SMEs in Hong Kong. The AASC considered these thresholds as suitable benchmarks for determining the quantitative thresholds for applying the HKSA for LCE. The quantitative thresholds may be re-assessed when the Institute conducts the post implementation review of its major standards.

49. The AASC noted a respondent's comment that the HKSA for LCE should be applicable to all non-PIE entities without any quantitative threshold. Another respondent expressed concern that establishing quantitative thresholds could complicate the application of the HKSA for LCE, potentially distorting the original intention of the ISA for LCE (paragraph 45).

50. In this context, the AASC noted that the IAASB anticipates local standard-setting bodies to develop quantitative thresholds as a safeguard on the appropriate use of the standard.[19] Specifically, The ISA for LCE - Authority Supplemental Guidance noted that the inclusion of quantitative thresholds will help users of the standard understand its scope and assist with the consistent and appropriate use of the standard in a jurisdiction. The use of quantitative thresholds may also serve as an additional safeguard to limit the range of entities perceived to be within the scope of the standard. Considering the mandatory auditing regime and the numerous CPA firms in Hong Kong (paragraph 4), it is essential for the AASC to clearly define the types of entities for which the use of the HKSA for LCE would be inappropriate. Therefore, the AASC considered that implementing quantitative thresholds, along with specific prohibitions and assessments based on the qualitative characteristics of an entity, is necessary to ensure the appropriate use of the HKSA for LCE in Hong Kong.

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19 IAASB Basis for Conclusions: ISA for LCE, paragraph 55

51. Considering the aforementioned factors, the AASC concluded that the proposed thresholds in paragraph 43 remained appropriate for determining the eligible use of the HKSA for LCE. The AASC also determined that it is unnecessary to introduce an automatic approach for adopting future amendments to the CO's size test. Any future changes to the size thresholds in the CO reporting exemption, which serve a different purpose than those in the HKSA for LCE, should be thoroughly examined and carefully considered by the AASC from a standard-setter perspective before determining if amendments to the HKSA for LCE thresholds are necessary.

52. Meanwhile, the AASC observed that a few respondents expressed concerns regarding the calculation of the number of employees of the entity or a group of entities. One respondent suggested that the calculation should be simplified, while another expressed concerns about the potentially ambiguous classification of full-time or part-time employment in specific situations. The respondent proposed that the definition of an employee should align with the definition in the Employment Ordinance. Additionally, clarification was sought regarding whether the number of employees referred to in the quantitative thresholds also includes entities that are accounted for using the equity method of accounting.

53. When developing the basis for the number of employees in the quantitative thresholds, the AASC made reference to the reporting exemption criteria in the CO. The AASC acknowledged that no single proposal would be flawless; however, it emphasized the necessity of establishing principles to ensure consistent application of thresholds among auditors in Hong Kong. Therefore, the AASC reaffirmed the validity of the proposed basis for ascertaining the number of employees and considered it reasonable to be calculated in a manner consistent with the CO reporting exemption.

54. Regarding the scope of the number of employees, particularly whether entities accounted for using the equity method should be encompassed, the AASC considered it crucial to understand the definition of "group financial statements" in the HKSA for LCE, which *include the financial information of more than one entity or business unit through a consolidation process.* Meanwhile, for purposes of the HKSA for LCE, a consolidation process includes:

    (a) *Consolidation, proportionate consolidation, or an equity method of accounting;*

    (b) *The presentation in combined financial statements of the financial information of entities or business units that have no parent but are under common control or common management; or*

    (c) *The aggregation of the financial information of entities or business units such as branches or divisions.*

55. Apparently, "group financial statements" within the context of the HKSA for LCE includes all entities or business units with the group. As a result, the AASC determined that when assessing the total number of employees for the quantitative thresholds outlined in paragraph 43, it is essential to consider employees from all entities or business units that comprise the group.

Applying the Quantitative Thresholds in Practice

56. The AASC's proposal in the ED also included:

- Entities currently using the HKSA for LCE can continue using the HKSA for LCE until they fail the quantitative thresholds for two consecutive years. They will lose eligibility in the reporting period after failing to meet the thresholds for the two immediately preceding financial years.
- However, a group will lose its eligibility to use the HKSA for LCE immediately if a new entity joins and causes the group to exceed the quantitative thresholds in that financial year. This loss of eligibility occurs without the two-year grace period mentioned above.

Respondents' Comments to the ED and AASC Decisions

57. Majority of respondents were supportive to the above proposals. Notwithstanding their support, a few respondents provided the following comments:

(a) The two-year rule proposed in paragraph 56 could potentially complicate the eligibility assessment. One suggestion proposed that the thresholds should be assessed exclusively on the current financial year being audited.

(b) The proposal might create bias. For example, entities undergoing organic growth and expansion may still apply the HKSA for LCE for up to an additional two years after failing the quantitative thresholds. On the other hand, groups that surpass the thresholds due to the inclusion of a new entity would be ceased to use the HKAS for LCE in the year of the joining.

(c) Entities might acquire assets such as investment properties or licenses and subsequently reposition them through intragroup arrangements instead of acquiring asset-holding entities. These approaches may have similar overall financial impacts. However, in the latter case, application of HKSA for LCE would be prohibited.

(d) For groups experiencing organic growth or expansion, it can be challenging to determine whether the size threshold has been exceeded due to the addition of a new entity or the growth of existing entities.

(e) Clarification was sought on whether a newly established subsidiary or an equity method investee is considered as having "joined" the group.

58. Concerning the two-year rule, the AASC maintained its view that it is important to maintain stability by using the same auditing standard consistently, rather than making frequent switches from year to year. Therefore, the AASC continued the decision to implement the two-year rule for the quantitative threshold assessment in the HKSA for LCE.

59. The AASC noted the comments regarding "potential bias" outlined in paragraph 57(b) but respectfully disagreed. The addition of a new entity to a group may indicate a certain level of complexity. For example, to integrate the new entity, it may be necessary for the group to redesign or reengineer internal controls, processes, systems, etc. over the

financial reporting and consolidation process to accommodate the inclusion of a new entity, increasing the group's complexity. Therefore, compared with a group experiencing organic growth and expansion, in the case of a new entity joining the group, it is necessary for the group auditor to assess whether the continued use of HKSA for LCE is appropriate.

60. The AASC also noted a concern in paragraph 57(c) that the proposal in paragraph 56 would present potential bias against acquiring an entity compared to acquiring an asset. The AASC emphasized that integrating a new entity into an existing group may change the fundamental attributes of that group in a way that undermines the original eligibility criteria, including the quantitative thresholds. Had this new entity been part of the group from the beginning, the group might not have initially met the quantitative thresholds. The breach of these thresholds due to the addition of a new entity is not caused by fluctuations in the sizes or activities of existing group entities but directly linked to the new entity, whose size was not considered in the initial eligibility assessment for utilizing the HKSA for LCE.

61. The AASC also believes that it is important to consider whether a specific transaction or situation might involve complex accounting treatments or present complexities that make using the HKSA for LCE inappropriate in an audit engagement. As a result, in determining whether the addition of a new entity justifies the continued use of the HKSA for LCE, the quantitative threshold is just one of the three criteria to consider. For instance, as noted in paragraph A.3. of the HKSA for LCE, additional qualitative characteristics relevant to group audits include *the group has few entities or business units, e.g., 5 or less.* Consequently, at a standard-setter level, the AASC considered it necessary to prohibit the use of the HKSA for LCE when a new entity joining the group that causes it exceeds the threshold to ensure the consistent and appropriate use of the HKSA for LCE. However, auditors should evaluate the totality of facts and circumstances on all three levels of eligibility criteria (paragraph 6), to ensure the continued use of the HKSA for LCE remains appropriate.

62. In exceptional situations, the AASC recognized the difficulty auditors face in distinguishing whether a threshold failure results from the group's organic growth or the inclusion of a new entity. The AASC noted that this assessment requires significant professional judgment and a careful evaluation of the specific facts and circumstances. However, as outlined in the EMM to paragraph A.3. of the HKSA for LCE, *notwithstanding that professional judgment is applied in determining whether the HKSA for LCE is appropriate to use, if there is uncertainty about whether an audit meets the criteria as set out in this Authority, the use of the HKSA for LCE is not appropriate*.

63. When reviewing respondents' comments, the AASC noted that there was ambiguity regarding whether entities accounted for using equity method of accounting should be factored into the relevant assessment. Given that group financial statements encompass the group's entities or business units (paragraph 54), the AASC agreed to enhance clarity by revising the requirement to include "business entity" in determining the quantitative thresholds when a new entity or *business unit* enters the group.

VII. Other Comments

64. Among the comments received, the AASC noted feedback concerning the implementation of the HKSA for LCEs. These include issues such as:

- The expectation gap where financial statement users might perceive higher assurance in the full Hong Kong Standards on Auditing ("HKSAs") compared to HKSA for LCE audits.
- Potential client expectations for reduced audit work and fees impacting audit quality.
- Initial challenges auditors may face in developing tailored procedures for HKSA for LCE.
- A call for clarification on how audits under the HKSA for LCE can maintain the same level of assurance during the stability period from December 2025 to 2028 when the HKSAs are converged with the new and revised requirements in the ISAs.

65. Comments have highlighted that education is essential for supporting the implementation of the HKSA for LCE. Key suggestions included:

- **Explaining the Benefits**: Providing clear communication on the advantages of adopting the HKSA for LCE to ensure stakeholders understand its value.
- **Revising the Audit Practice Manual**: Updating the Institute's Audit Practice Manual specifically for the HKSA for LCE to reflect the requirements and practices.
- **Developing Illustrative Examples**: Developing practical examples to facilitate understanding and implementation of the HKSA for LCE, helping auditors navigate practical scenarios effectively.

66. The AASC is developing plans and strategies to facilitate the adoption and implementation of the HKSA for LCE. They may encompass training sessions on the appropriate use of the HKSA for LCE; locally developed materials such as FAQs to aid in the application of the HKSA for LCE within the Hong Kong context. Where appropriate, the AASC will utilize the implementation guide and other resources developed by the IAASB and converge them into a Hong Kong context as educational initiatives for the HKSA for LCE.

67. The Institute adopts a policy of convergence with standards issued by the IAASB. Consequently, any future updates to the HKSA for LCE, apart from the locally developed provisions and guidance, will align with those of the ISA for LCE initiated by the IAASB.

68. Regarding the locally developed provisions and guidance on the use of the HKSA for LCE, the AASC will perform periodic assessment to evaluate their relevance over time and, if needed, initiate revisions to ensure their suitability.

VIII. Mandatory Disclosure Requirements in the Auditor's Report under HKSA 700 (Revised)

69. In November 2024, the AASC released an exposure draft *Proposed Amendments to Hong Kong Standard on Auditing 700 (Revised), Forming an Opinion and Reporting on Financial Statements and Proposed Conforming and Consequential Amendments to Other Hong Kong Standards on Auditing and Other Non-authoritative Materials* for public comments.

70. The proposed amendments to HKSA 700 (Revised) and the consequential amendments to other HKSAs and other non-authoritative materials introduce the mandatory disclosure of the auditor's name and practising certificate number in the auditor's report for an audit of an entity's financial statements prepared for reporting under the laws and regulations in Hong Kong conducted by a practice unit in accordance with HKSAs ("mandatory disclosure requirements"). The intention is to enhance transparency for users of the auditor's report on financial statements of all entities, including both public interest entities and non-public interest entities.

71. After considering comments received during the exposure draft period, the AASC reaffirmed its position on the proposal in paragraph 70. The final pronouncement was issued in March 2025,[20] and it is effective for audits of financial statements for periods ending on or after 31 March 2025. Early adoption will be permitted and encouraged to facilitate audit clients when preparing their profits tax returns for the year of assessment 2024/25.

72. At the time of the consultation mentioned in paragraph 69, the HKSA for LCE had not yet been released. Consequently, the scope of the consultation did not cover the mandatory disclosure requirements for auditor's reports in accordance with the HKSA for LCE. Nonetheless, the AASC recognized that the purpose of these mandatory disclosure requirements is to enhance transparency for users of the auditor's report, regardless of the auditing standards applied. To ensure consistency and the same objective for audits under the HKSAs and the HKSA for LCE, the AASC concluded that these mandatory disclosure requirements should be applied to audits under the HKSA for LCE without further consultation. The AASC noted that the consultation described in paragraphs 69 to 70 effectively gathered stakeholder feedback on the principles of these requirements, which the AASC considered in their final decision regarding HKSA 700 (Revised), other HKSAs and non-authoritative materials (paragraph 71). In light of this, the AASC determined to include an additional locally developed paragraph 9.4.1-1 in the HKSA for LCE to implement the mandatory disclosure requirements for audits conducted under the HKSA for LCE.

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[20] Amendments to Hong Kong Standard on Auditing 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* for mandatory disclosure of the auditor's name and practising certificate number and the accompanying Basis for Conclusions were issued on 18 March 2025 in Members' Handbook Update No. 326.

IX. Impact Analysis

73. The HKSA for LCE aims to enhance the effectiveness and efficiency of audits for LCEs while ensuring high-quality outcomes. When applying the HKSA for LCE, auditors should be aware of the following key areas that may impact their application.

74. ***Standalone nature of the HKSA for LCE.*** The HKSA for LCE is a standalone, self-contained standard. It covers requirements relevant to the typical nature and circumstances of an audit of an LCE, and with no intended need to reference back to the HKSAs.[21] Accordingly, auditors applying the HKSA for LCE must exercise caution from inadvertently reverting to HKSA requirements in areas not covered by the HKSA for LCE. Therefore, it is essential for auditors to conduct a thorough and comprehensive assessment of eligibility for using the HKSA for LCE, evaluating the relevant characteristics of an entity individually and collectively, to ensure that the relevant audit engagement will be adequately addressed by requirements in the HKSA for LCE.

75. ***Needing to navigate different sections for the same topic.*** The HKSA for LCE is designed to align with the flow of an audit engagement. In contrast to the HKSAs, which typically address a single topic—from risk assessment procedures and evaluation to auditor conclusions and reporting—within one standard, the HKSA for LCE organizes its requirements into distinct parts corresponding to the various stages of an audit. This structure requires auditors to refer to different parts for requirements related to the same topic.

    For example, when addressing "going concern," auditors must refer to different parts in the HKSA for LCE for relevant requirements and EEM:

    - Risk identification and Assessment: Part 6
    - Responding to Assessed Risks of Material Misstatement: Part 7
    - Concluding: Part 8
    - Forming an Opinion: Part 9

76. ***Qualitative characteristics relating to accounting estimates.*** Paragraph A.3. of the HKSA for LCE describes an LCE in the context of accounting estimates as:

    (a) Having few accounts or disclosures in the financial statements that necessitate the use of significant management judgment in applying the requirements of the financial reporting framework.

    (b) The financial statements ordinarily do not include accounting estimates that involve the use of methods, models, assumptions, or data, that are complex.

    For instance, fair value accounting estimates that use unobservable inputs to measure the fair value of the asset or liability, known as Level 3 inputs under International Financial Reporting Standards, are commonly not associated with LCEs.[22]

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[21] IAASB Basis for Conclusions: ISA for LCE, paragraph 30

[22] IAASB ISA for LCE Authority Supplemental Guidance

Meanwhile, the IAASB clarified that the presence of one or a small number of accounting estimates with a higher degree of complexity may not be indicative of the complexity of the entity as a whole. The standard's focus is not on the isolated or "one-off" accounting estimates or transactions that do not otherwise increase the complexity of the entity as a whole".[23]

In Hong Kong, it is common for non-regulated private entities, without substantial businesses and/or operations, holding investment properties with fair value determined using unobservable inputs. These entities would otherwise qualify for using the HKSA For LCE in their audits. Following the IAASB's clarification outlined above, auditors must exercise professional judgment in determining whether an entity's accounting estimate with unobservable inputs is isolated or "one-off", or relates to the entity's main business activities which would be likely to be an indicator of complexity more pervasively and thus preclude the use of the HKSA for LCE.

77. ***No illustration on modified opinions.*** The HKSA for LCE does not provide illustrative examples of modified opinions. Auditors must refer to separate publications[24] for relevant guidance and illustration when and as necessary.

78. ***Timing differences with HKSA updates***. The HKSA for LCE is converged with the ISA for LCE. Any maintenance of the HKSA for LCE, other than local refinements and guidance, will follow the updates made to the ISA for LCE.

After the ISA for LCE becomes effective on 15 December 2025, there will be an initial period of stability of at least three years. This means that any possible future revisions to the ISA for LCE would not become effective before 15 December 2028. This initial period of stability provides stakeholders time to adopt and implement the standard before introducing any possible revisions.[25] However, it also means that the new and revised requirements in the ISAs/HKSAs that become effective between 2025 and 2028 may diverge from those in the ISA for LCE/HKSA for LCE. Consequently, auditors must apply different requirements across audit engagements of the HKSAs and the HKSA for LCE on the same topic. This divergence may include, but is not limited to, the following ISAs and their corresponding HKSAs:

Standard	Effective Date
ISA 570 (Revised 2024), Going Concern	Audits of financial statements for periods beginning on or after 15 December 2026
ISA 240 (Revised), The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	Audits of financial statements for periods beginning on or after 15 December 2026 (tentative)

23 IAASB Basis for Conclusions: ISA for LCE, paragraph 53

24 For example, IAASB ISA for LCE Authority Reporting Supplemental Guidance

25 IAASB Basis for Conclusions: ISA for LCE, paragraph 142

Annex 1: Request for Specific Comments in the Exposure Draft

1. Do you agree that entities falling within the definition of a PIE in Chapter A of the HKICPA Code, including any future local amendments made to the PIE definition in Chapter A of the HKICPA Code, should be prohibited from applying the HKSA for LCE in their audit of financial statements? If not, why not?

2. Do you agree with not specifically prohibiting a non-bank money lender within the meaning of the MLO from using the HKSA for LCE in its audit of financial statements? If not, why not?

3. Do you agree to modify the specific prohibition in paragraph A.1.(c) to prohibit the following entities from using the HKSA for LCE in their audit of financial statements? If not, why not?
   - Entities that carry on any banking business and are authorized institutions as defined under the BO;
   - Entities that carry on any insurance business and are authorized insurers as defined under the IO;
   - Entities that are licensed corporations under Part V of the SFO to carry on a business in any regulated activity within the meaning of the SFO; and
   - Public interest entities defined in Part 4A, Chapter A of the HKICPA Code.

4. In determining the appropriate use of the HKSA for LCE, in addition to the specific prohibitions in paragraph A.1. and meeting the qualitative characteristics in paragraph A.3., do you agree that an entity or a group of entities should not exceed any two of the following?
   (a) Annual revenue of HK$200 million
   (b) Total assets of HK$200 million at the end of the reporting period
   (c) 100 employees

5. Do you agree with the following in applying the proposed quantitative thresholds to assess the use of the HKSA for LCE? If not, why not?
   (a) The general principle is that an entity or a group of entities will need to meet the proposed quantitative thresholds for the two immediately preceding reporting periods in order to be eligible to use the HKSA for LCE in that reporting period (subject to meeting all the other conditions), regardless of its size in that period. An exception applies to an entity which is a newly established entity, or a group of entities whose holding company is a newly established entity. In this case, the entity or group could use the HKSA for LCE in the audit of its first financial year if the entity or group meets the proposed quantitative thresholds and other requirements for using the HKSA for LCE in its first financial year.
   (b) An entity or a group of entities that already meets the criteria of and is using the HKSA for LCE in its audit of financial statements can continue using it until it fails the proposed quantitative thresholds for two consecutive financial years. It will only

lose the eligibility to use the HKSA for LCE in the reporting period following the two immediately preceding financial years in which it has failed to meet the proposed quantitative thresholds.

(c) A group of entities that meets the criteria of using the HKSA for LCE and has been using it in its audit of financial statements will lose the eligibility to use it in the financial year when a new entity enters the group and causes the group to exceed the proposed quantitative thresholds in that year. As a result, the group will lose its eligibility to use the HKSA for LCE immediately in its audit of financial statements in the year that the new entity enters the group, without the two-year grace period in (b).

(d) To evaluate the proposed quantitative thresholds, an auditor should use the entity's or the group's financial information of the two consecutive financial years immediately preceding the year that the auditor plans to use the HKSA for LCE in the audit of the entity or group financial statements. This is the case except for a newly established entity or a group of entities whose holding company is a newly established entity which intends to apply the HKSA for LCE in its first financial year (see (a) above).

6. Do you agree to apply the following bases to determine the quantitative thresholds for the eligible use of the HKSA for LCE? If not, why not?

   (a) The annual revenue and total assets are those reflected in the entity financial statements or group financial statements for the financial year;

   (b) In the case where the reporting period is shorter or longer than a year, the amount of annual revenue for a financial year is to be calculated on a pro-rata basis as if the length of the financial year was 12 months;

   (c) The number of employees is the average number of persons employed by the entity or group of entities during the reporting period (irrespective of whether in full-time or part-time employment) determined on a monthly basis as follows:

      (i) Determine the number of employees as at the end of each calendar month.

      (ii) Add together all the monthly numbers in (i).

      (iii) Divide the number in (ii) by the number of months in the reporting period.

7. Are there any other matters you would like to raise in relation to this exposure draft? If so, please clearly indicate the requirement(s) or material, or the theme or topic, to which your comment(s) relate.