



# MEMBERS' HANDBOOK

## Update No. 86

(Issued 2 June 2010)

Document Reference and Title	Instructions	Explanations
<b><u>VOLUME III</u></b>		
Contents of Volume III	Discard the existing pages i to vi and replace with the new pages i to vi.	Revised contents pages
<b>PRACTICE NOTES</b>		
PN 740 <a href="#"><u>Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules</u></a>	Insert these pages after PN730.	New Practice Note - Note 1
PN 900 (Clarified) <a href="#"><u>Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</u></a>	Insert these pages after PN 871.	Note 2
PN 900 (Revised) <a href="#"><u>Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</u></a>	Insert the revised pages 1,2 and 5 and discard the replaced pages 1, 2 and 5.	Note 3
PN 900 <i>Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</i>	Discard existing PN900.	PN 900 is superseded by PN 900 (Revised) and PN 900 (Clarified).

### Notes:

1. The purpose of PN 740 is to provide guidance to auditors as to their responsibilities and procedures when an auditor is engaged by a Hong Kong listed issuer to report on continuing connected transactions pursuant to Chapter 14A of the Main Board Listing Rules or Chapter 20 of the GEM Listing Rules issued by The Stock Exchange of Hong Kong Limited. This PN is effective for reporting on continuing connected transactions disclosed in annual reports for periods ending on or after 31 December 2010 with early adoption permissible.

2. PN 900 (Clarified) is issued to reflect compliance with the requirements of HKSA 700 (Clarified) "Forming an Opinion and Reporting on Financial Statements", HKSA 705 (Clarified) "Modifications to the Opinion in the Independent Auditor's Report" and HKSA 706 (Clarified) "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", for audits of financial statements for periods beginning on or after 15 December 2009.
3. PN 900 (Revised) is updated to reflect that it is effective for audits of financial statements for periods beginning before 15 December 2009.



**MEMBERS' HANDBOOK  
CONTENTS OF VOLUME III**

(Updated to June 2010)

		<i>Issue/Review date</i>
PREFACE	<a href="#"><u>PREFACE TO HONG KONG STANDARDS ON QUALITY CONTROL, AUDITING, ASSURANCE AND RELATED SERVICES</u></a> .....	2/05
GLOSSARY	<a href="#"><u>GLOSSARY OF TERMS RELATING TO HONG KONG STANDARDS ON QUALITY CONTROL, AUDITING, ASSURANCE AND RELATED SERVICES</u></a> .....	10/07
<b>HONG KONG STANDARDS ON QUALITY CONTROL (HKSQCs 1 – 99)</b>		
HKSQC 1	<a href="#"><u>Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements</u></a> .....	7/06
FRAMEWORK	<a href="#"><u>HONG KONG FRAMEWORK FOR ASSURANCE ENGAGEMENTS</u></a> .....	10/04
<b>HONG KONG STANDARDS ON AUDITING (HKSA 100 – 999)</b>		
HKSA 200 – 299	GENERAL PRINCIPLES AND RESPONSIBILITIES	
HKSA 200	<a href="#"><u>Objective and General Principles Governing an Audit of Financial Statements</u></a> .....	10/06
HKSA 200 (Revised)	<a href="#"><u>Objective and General Principles Governing an Audit of Financial Statements</u></a> .....	10/06
HKSA 210	<a href="#"><u>Terms of Audit Engagements</u></a> .....	3/07
HKSA 220	<a href="#"><u>Quality Control for Audits of Historical Financial Information</u></a> .....	10/04
HKSA 230	<a href="#"><u>Audit Documentation</u></a> .....	2/06
HKSA 240	<a href="#"><u>The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements</u></a> .....	10/04
HKSA 250	<a href="#"><u>Consideration of Laws and Regulations in an Audit of Financial Statements</u></a> .....	6/05
HKSA 260	<a href="#"><u>Communication of Audit Matters with Those Charged with Governance</u></a> .....	6/05
HKSA 300 – 499	RISK ASSESSMENT AND RESPONSE TO ASSESSED RISKS	
HKSA 300	<a href="#"><u>Planning an Audit of Financial Statements</u></a> .....	11/04
HKSA 315	<a href="#"><u>Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement</u></a> .....	11/04
HKSA 320	<a href="#"><u>Audit Materiality</u></a> .....	6/05
HKSA 330	<a href="#"><u>The Auditor's Procedures in Response to Assessed Risks</u></a> .....	7/06
HKSA 402	<a href="#"><u>Audit Considerations Relating to Entities Using Service Organizations</u></a> .....	6/05
HKSA 500 – 599	AUDIT EVIDENCE	
HKSA 500	<a href="#"><u>Audit Evidence</u></a> .....	11/04
HKSA 501	<a href="#"><u>Audit Evidence - Additional Considerations for Specific Items</u></a> .....	6/05
HKSA 505	<a href="#"><u>External Confirmations</u></a> .....	6/05
HKSA 510	<a href="#"><u>Initial Engagements - Opening Balances</u></a> .....	6/05

	<i>Issue/Review date</i>
HKSA 520 <a href="#">Analytical Procedures</a> .....	6/05
HKSA 530 <a href="#">Audit Sampling and Other Means of Testing</a> .....	6/05
HKSA 540 <a href="#">Audit of Accounting Estimates</a> .....	6/05
HKSA 545 <a href="#">Auditing Fair Value Measurements and Disclosures</a> .....	6/05
HKSA 550 <a href="#">Related Parties</a> .....	6/05
HKSA 560 <a href="#">Subsequent Events</a> .....	10/06
HKSA 560 (Revised) <a href="#">Subsequent Events</a> .....	10/06
HKSA 570 <a href="#">Going Concern</a> .....	6/05
HKSA 580 <a href="#">Management Representations</a> .....	6/05
HKSA 600 – 699 <b>USING THE WORK OF OTHERS</b>	
HKSA 610 <a href="#">Considering the Work of Internal Audit</a> .....	6/05
HKSA 620 <a href="#">Using the Work of an Expert</a> .....	6/05
HKSA 700 – 799 <b>AUDIT CONCLUSIONS AND REPORTING</b>	
HKSA 700 <a href="#">The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements</a> .....	10/06
HKSA 701 <a href="#">Modifications to the Independent Auditor’s Report</a> .....	10/06
HKSA 710 <a href="#">Comparatives</a> .....	6/05
HKSA 720 <a href="#">Other Information in Documents Containing Audited Financial Statements</a> .....	6/05
<b>HONG KONG STANDARDS ON REVIEW ENGAGEMENTS (HKSREs 2000 – 2699)</b>	
HKSRE 2400 <a href="#">Engagements to Review Financial Statements</a> .....	3/08
HKSRE 2410 <a href="#">Review of Interim Financial Information Performed by the Independent Auditor of the Entity</a> .....	3/08
<b>HONG KONG STANDARDS ON ASSURANCE ENGAGEMENTS (HKSAEs 3000 – 3699)</b>	
HKSAE 3000 <a href="#">Assurance Engagements Other Than Audits or Reviews of Historical Financial Information</a> .....	10/04
HKSAE 3402 <a href="#">Assurance Reports on Controls at a Service Organization</a> .....	05/10
<b>HONG KONG STANDARDS ON INVESTMENT CIRCULAR REPORTING ENGAGEMENTS (HKSIRs 100 – 999)</b>	
HKSIR 300 <a href="#">Accountants’ Reports on Pro Forma Financial Information in Investment Circulars</a> .....	3/06
HKSIR 400 <a href="#">Comfort Letters and Due Diligence Meetings on Financial and Non-financial Information</a> .....	10/05
<b>HONG KONG STANDARDS ON RELATED SERVICES (HKSRs 4000 – 4699)</b>	
HKSRs 4400 <a href="#">Engagements to Perform Agreed-upon Procedures Regarding Financial Information</a> .....	11/04

	<i>Issue/Review date</i>
HKSRS 4410 <a href="#">Engagements to Compile Financial Statements</a> .....	11/04
 <b>STATEMENTS OF AUDITING STANDARDS</b>	
<b>Audits of financial statements</b>	
SAS 510 <a href="#">Principal auditors and other auditors</a> .....	7/97
 <b>PRACTICE NOTES</b>	
PN 600.1 <a href="#">Reports by auditors under the Hong Kong Companies Ordinance</a> .....	9/04
PN 600.2 <a href="#">Audit approach to companies applying section 141D of the Companies Ordinance</a> .....	12/05
PN 620.2 <a href="#">Communications between auditors and the Insurance Authority</a> .....	9/04
PN 710 <a href="#">The auditors' statement on the summary financial report</a> .....	9/04
PN 720 <a href="#">Acting as Scrutineer at a General Meeting of a Listed Issuer</a> .....	7/05
PN 730 <a href="#">Guidance for Auditors Regarding Preliminary Announcements of Annual Results</a> .....	12/05
PN 740 <a href="#">Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules</a> .....	6/10
PN 810.1 <a href="#">Insurance brokers - compliance with the minimum requirements specified by the Insurance Authority under sections 69(2) and 70(2) of the Insurance Companies Ordinance</a> .....	9/04
PN 810.2 <a href="#">The duties of auditors under the Insurance Companies Ordinance</a> .....	9/04
PN 820 <a href="#">The audit of licensed corporations and associated entities of intermediaries</a> .....	3/08
PN 830 <a href="#">Reports by Auditors Under the Banking Ordinance</a> .....	1/05
PN 840 <a href="#">The audit of solicitors' accounts under the Solicitors' Accounts Rules and the Accountant's Report Rules</a> .....	9/04
PN 850 <a href="#">Review of flag day accounts</a> .....	9/04
PN 851 <a href="#">Review of the Annual Financial Reports of Non-governmental Organisations</a> .....	9/04
PN 852 <a href="#">Review of lottery accounts</a> .....	9/04
PN 860.1 <a href="#">The audit of retirement schemes</a> .....	9/04
PN 860.2 <a href="#">Reports on internal controls of investment custodians made available to third parties</a> .....	5/10
PN 870 <a href="#">The assessments of Certification Authorities under the Electronic Transactions Ordinance</a> .....	9/04
PN 871 <a href="#">Engagement to report on compliance with the Billing and Metering Integrity Scheme of OFTA</a> .....	9/04
PN 900 (Clarified) <a href="#">Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</a> .....	6/10
PN 900 (Revised) <a href="#">Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</a> .....	6/10
PN 1000 <a href="#">Inter-bank confirmation procedures</a> .....	9/04
PN 1001 <a href="#">IT Environments - Stand-alone personal computers</a> .....	9/04
PN 1002 <a href="#">IT Environments - On-line computer systems</a> .....	9/04
PN 1003 <a href="#">IT Environments - Database systems</a> .....	9/04
PN 1009 <a href="#">Computer-assisted audit techniques</a> .....	9/04

		<i>Issue/Review date</i>
PN 1010	<a href="#">The consideration of environmental matters in the audit of financial statements</a> .....	9/04
PN 1012	<a href="#">Auditing derivative financial instruments</a> .....	9/04
PN 1013	<a href="#">Electronic commerce - Effect on the audit of financial statements</a> .....	9/04
 <b>AUDITING GUIDELINES</b>		
AG 3.283	<a href="#">Guidance for internal auditors</a> .....	9/04
AG 3.340	<a href="#">Prospectuses and the reporting accountant</a> .....	9/04
AG 3.341	<a href="#">Accountants' report on profit forecasts</a> .....	9/04
 <b>INDUSTRY AUDITING GUIDELINES</b>		
IAG 3.406	<a href="#">Banks and deposit-taking companies - the amended section 161B and section 161BA of the Companies Ordinance</a> .....	9/04
 <b>HONG KONG CLARIFIED PRONOUNCEMENTS ON AUDITING</b>		
Preface (Revised)	<a href="#">Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services</a> .....	05/10
Glossary (Clarified)	<a href="#">Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services</a> .....	09/09
 <b>HONG KONG STANDARDS ON QUALITY CONTROL</b>		
HKSQC 1 (Clarified)	<a href="#">Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements</a> .....	06/09
 <b>AUDITS OF HISTORICAL FINANCIAL INFORMATION</b>		
HKSA 200 – 299 GENERAL PRINCIPLES AND RESPONSIBILITIES		
HKSA 200 (Clarified)	<a href="#">Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing</a> .....	06/09
HKSA 210 (Clarified)	<a href="#">Agreeing The Terms of Audit Engagements</a> .....	06/09
HKSA 220 (Clarified)	<a href="#">Quality Control for an Audit of Financial Statements</a> .....	06/09
HKSA 230 (Clarified)	<a href="#">Audit Documentation</a> .....	06/09
HKSA 240 (Clarified)	<a href="#">The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</a> .....	07/09
HKSA 250 (Clarified)	<a href="#">Consideration of Laws and Regulations in an Audit of Financial Statements</a> ...	07/09
HKSA 260 (Clarified)	<a href="#">Communication with Those Charged with Governance</a> .....	06/09
HKSA 265 (Clarified)	<a href="#">Communicating Deficiencies in Internal Control to Those Charged with Governance and Management</a> .....	06/09
 HKSA 300 – 499 RISK ASSESSMENT AND RESPONSE TO ASSESSED RISKS		
HKSA 300 (Clarified)	<a href="#">Planning an Audit of Financial Statements</a> .....	06/09

	<i>Issue/Review date</i>
HKSA 315 (Clarified)	<a href="#"><u>Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</u></a> ..... 06/09
HKSA 320 (Clarified)	<a href="#"><u>Materiality in Planning and Performing an Audit</u></a> ..... 06/09
HKSA 330 (Clarified)	<a href="#"><u>The Auditor's Responses to Assessed Risks</u></a> ..... 06/09
HKSA 402 (Clarified)	<a href="#"><u>Audit Considerations Relating to an Entity Using a Service Organization</u></a> ..... 07/09
HKSA 450 (Clarified)	<a href="#"><u>Evaluation of Misstatements Identified during the Audit</u></a> ..... 07/09
HKSA 500 – 599	AUDIT EVIDENCE
HKSA 500 (Clarified)	<a href="#"><u>Audit Evidence</u></a> ..... 07/09
HKSA 501 (Clarified)	<a href="#"><u>Audit Evidence - Specific Considerations for Selected Items</u></a> ..... 07/09
HKSA 510 (Clarified)	<a href="#"><u>Initial Audit Engagements - Opening Balances</u></a> ..... 09/09
HKSA 520 (Clarified)	<a href="#"><u>Analytical Procedures</u></a> ..... 07/09
HKSA 530 (Clarified)	<a href="#"><u>Audit Sampling</u></a> ..... 07/09
HKSA 540 (Clarified)	<a href="#"><u>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</u></a> ..... 07/09
HKSA 550 (Clarified)	<a href="#"><u>Related Parties</u></a> ..... 07/09
HKSA 560 (Clarified)	<a href="#"><u>Subsequent Events</u></a> ..... 07/09
HKSA 570 (Clarified)	<a href="#"><u>Going Concern</u></a> ..... 07/09
HKSA 580 (Clarified)	<a href="#"><u>Written Representations</u></a> ..... 07/09
HKSA 600 – 699	USING THE WORK OF OTHERS
HKSA 600 (Clarified)	<a href="#"><u>Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)</u></a> ..... 09/09
HKSA 610 (Clarified)	<a href="#"><u>Using the Work of Internal Auditors</u></a> ..... 07/09
HKSA 620 (Clarified)	<a href="#"><u>Using the Work of an Auditor's Expert</u></a> ..... 07/09
HKSA 700 – 799	AUDIT CONCLUSIONS AND REPORTING
HKSA 700 (Clarified)	<a href="#"><u>Forming an Opinion and Reporting on Financial Statements</u></a> ..... 09/09
HKSA 705 (Clarified)	<a href="#"><u>Modifications to the Opinion in the Independent Auditor's Report</u></a> ..... 09/09
HKSA 706 (Clarified)	<a href="#"><u>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report</u></a> ..... 09/09
HKSA 710 (Clarified)	<a href="#"><u>Comparative Information – Corresponding Figures and Comparative Financial Statements</u></a> ..... 09/09

		<i>Issue/Review date</i>
HKSA 720 (Clarified)	<a href="#"><u>The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements</u></a> .....	09/09
HKAS 800 - 899	SPECIALIZED AREAS	
HKSA 800 (Clarified)	<a href="#"><u>Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks</u></a> .....	10/09
HKSA 805 (Clarified)	<a href="#"><u>Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement</u></a> .....	10/09
HKSA 810 (Clarified)	<a href="#"><u>Engagements to Report on Summary Financial Statements</u></a> .....	10/09



Effective for reporting on  
continuing connected  
transactions disclosed in annual  
reports for periods ending on or  
after 31 December 2010

*Practice Note 740*

---

# **Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules**



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

## PRACTICE NOTE 740

# AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS UNDER THE HONG KONG LISTING RULES

(Issued June 2010)

<i>Contents</i>	<i>Paragraphs</i>
<b>Introduction</b>	<b>1-8</b>
<b>Directors' responsibilities</b>	<b>9-15</b>
<b>Auditor's responsibilities</b>	<b>16-19</b>
<b>General considerations</b>	<b>20-60</b>
● Completeness of identification of connected persons and transactions	20-25
● Nature of the engagement to be performed	26-28
● Terms of engagement	29-31
● Extent of testing and sampling	32-34
● Materiality	35-41
● Interaction with the annual audit	42-43
● Risks of fraud and error	44-47
● Skepticism	48
● Written representations	49-53
● Communication with those charged with governance	54-60
<b>Specific considerations</b>	<b>61-93</b>
● Reporting on approval by directors	62-63
● Reporting as to whether transactions complied with the listed issuer's pricing policies	64-78
● Reporting as to whether transactions were entered into in accordance with the relevant agreement	79-89
● Reporting on whether transactions are within the maximum aggregate annual amount ("cap")	90-93
<b>Reporting</b>	<b>94-104</b>
● General aspects	94-101
● References to auditor's letter in the annual report	102-104
<b>Documentation</b>	<b>105</b>
<b>Effective date</b>	<b>106</b>
<b>Appendix 1</b>	<b>Summary of relevant Main Board Listing Rules and GEM Listing Rules</b>
<b>Appendix 2</b>	<b>Example Independent Auditor's Letter on Continuing Connected Transactions</b>
<b>Appendix 3</b>	<b>Example Engagement Letter</b>
<b>Appendix 4</b>	<b>Example Representation Letter</b>

## PRACTICE NOTE 740

### AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS UNDER THE HONG KONG LISTING RULES

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

*Practice Notes are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in Hong Kong Engagement Standards. This Practice Note provides guidance to assist the auditor to fulfill the objectives of the engagement. The auditor should be prepared to explain departures when called upon to do so.*

#### Introduction

1. The purpose of this Practice Note is to provide guidance to auditors as to their responsibilities and procedures when an auditor is engaged by a Hong Kong listed issuer to report on continuing connected transactions pursuant to Chapter 14A of the Main Board Listing Rules or Chapter 20 of the GEM Listing Rules issued by The Stock Exchange of Hong Kong Limited (the "Stock Exchange"). The term "auditor" is used throughout this Practice Note, not because the auditor is performing an audit function but because engagements to issue a letter under Chapter 14A of the Main Board Listing Rules or Chapter 20 of the GEM Listing Rules on continuing connected transactions is expected to be performed by the same independent auditor who audited the annual financial statements of the entity. This Practice Note primarily addresses the significant issues commonly encountered by the auditor when undertaking the engagement and summarises the principal matters which should be taken into consideration by the auditor when designing, carrying out, and evaluating the outcome of, his procedures.
2. Chapter 14A of the Main Board Listing Rules and Chapter 20 of GEM Listing Rules set out a number of requirements in respect of connected transactions which are intended to ensure that when the listed issuer enters into connected transactions, the interests of shareholders as a whole are taken into account by a listed issuer and to provide certain safeguards against a listed issuer's directors, management and substantial shareholders (or their associates) taking advantage of their positions. Amongst other things, the Listing Rules require certain continuing connected transactions be approved by independent shareholders, reviewed by independent non-executive directors, and be subject to reporting and announcement requirements. In particular, Main Board Listing Rule 14A.38 and GEM Listing Rule 20.38 require that each year, a listed issuer should request its auditor to issue a letter in respect of continuing connected transactions. Main Board Listing Rule 14A.39 / GEM Listing Rule 20.39 requires that the listed issuer's board of directors must state in the annual report whether its auditor has confirmed the matters stated in Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38.
3. It should be borne in mind that the definition of "connected person" in accordance with the Listing Rules is different from the definition of "related party" as set out in Hong Kong Accounting Standard 24 ("HKAS 24") "Related Party Disclosures". However, there are many similarities in the issues associated with related parties and connected persons.
4. Related party / connected person relationships and transactions are often a common feature of commerce and business. Related party / connected person relationships could also have an effect on an entity's financial and operating policies. An entity may enter into transactions with related parties / connected persons that any other third party would not and that could have a material effect on the entity's performance and financial position. Related party / connected person relationships may also give rise to higher risk of management and substantial shareholders taking advantage of their position and not acting in the interests of minority shareholders.

5. An auditor undertaking an engagement with reference to this Practice Note would undertake a limited assurance engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" ("HKSAE 3000") to enable him to express a conclusion whether, on the basis of the work undertaken, anything has come to the auditor's attention that causes the auditor to believe that the matters in respect of which he is required to report (as more fully explained in this Practice Note) have not been complied with, in all material respects.
6. This Practice Note has been prepared to give guidance in respect of such a limited assurance engagement undertaken in accordance with HKSAE 3000. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the information in respect of the disclosed continuing connected transactions is materially misstated in the listed issuer's annual report.
7. The objective of an engagement undertaken with reference to this Practice Note differs significantly from that of an audit conducted in accordance with Hong Kong Standards on Auditing (HKSAAs). An engagement under this Practice Note does not provide a basis for expressing an opinion on whether the continuing connected transactions disclosed in the listed issuer's annual report give a true and fair view, or are presented fairly, in all material respects, in accordance with an applicable financial reporting framework or whether the listed issuer has complied with all the applicable requirements of the Listing Rules in respect of continuing connected transactions.
8. This Practice Note has been prepared in consultation with the Stock Exchange and staff at the Hong Kong Securities and Futures Commission (SFC) and is based on the Stock Exchange's Listing Rules as at 20 May 2010. A summary of relevant Listing Rules is set out in Appendix 1 to this Practice Note.

### **Directors' responsibilities**

9. The directors of a listed issuer are responsible for the identification of all connected transactions, including continuing connected transactions, the disclosures of connected transactions in the listed issuer's annual report, obtaining the independent shareholders' approval for connected transactions where required, and the listed issuer's compliance with the Listing Rules and relevant laws and regulations.
10. The directors are responsible for ensuring that the listed issuer has appropriate internal controls in place over the identification, recording, authorization and reporting of all connected transactions. This responsibility means that the listed issuer should implement adequate internal controls to ensure that connected persons as well as all transactions with connected persons are appropriately identified in the listed issuer's information system; and to prevent and detect fraud and error.
11. When the listed issuer engages its auditor to report on continuing connected transactions pursuant to the Listing Rules, the listed issuer is responsible for ensuring the auditor is granted sufficient access to records of the listed issuer and the connected persons pursuant to the Main Board Listing Rule 14A.39 / GEM Listing Rule 20.39.
12. Under Main Board Listing Rule 14A.40 / GEM Listing Rule 20.40, a listed issuer shall promptly notify the Stock Exchange and publish an announcement if it knows or has reason to believe that the independent non-executive directors and / or the auditor will not be able to confirm the matters set out in Main Board Listing Rule 14A.37 and / or 14A.38 / GEM Listing Rule 20.37 and / or 20.38 respectively. The listed issuer may have to re-comply with Main Board Listing Rule 14A.35(3) and (4) / GEM Listing Rule 20.35(3) and (4) and any other conditions the Stock Exchange considers appropriate.

13. Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38 requires that a copy of the auditor's letter on continuing connected transactions should be provided to the Stock Exchange not less than 10 business days prior to the bulk printing of the listed issuer's annual report. The listed issuer's directors are responsible for ensuring that the auditor is provided on a timely basis with the information the auditor requires to enable the letter to be issued in accordance with the Stock Exchange's timeline. For example, under paragraph 49 of this Practice Note, when a listed issuer engages its auditor to issue a letter with reference to this Practice Note, the auditor should obtain a representation letter from the listed issuer's directors. If the listed issuer needs to convene a board meeting to approve and issue that representation letter, the listed issuer should schedule the board meeting sufficiently ahead of the date of bulk printing of the annual report to take account of the Stock Exchange's timeline for receipt of the auditor's letter. The listed issuer's directors are also responsible for providing the auditor's letter to the Stock Exchange.
14. Under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37, the independent non-executive directors ("INEDs") are responsible for reviewing, and confirming in the annual report and accounts, whether the continuing connected transactions have been entered into:
  - (a) in the ordinary and usual course of business of the listed issuer;
  - (b) on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favorable to the listed issuer than terms available to or from, as appropriate, independent third parties; and
  - (c) in accordance with the relevant agreement governing them on terms that are fair and reasonable and in the interests of the shareholders of the listed issuer as a whole.
15. If the INEDs are unable to issue an unmodified confirmation required by Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37, the listed issuer is required under Listing Rule 14A.40 / GEM Listing Rule 20.40 to promptly notify the Stock Exchange and publish an announcement. In such circumstances, the auditor should discuss with the INEDs and management and consider the implications on his work and letter.

### **Auditor's responsibilities**

16. When reporting on continuing connected transactions pursuant to Chapter 14A of the Main Board Listing Rules or Chapter 20 of the GEM Listing Rules, the auditor would normally perform his work with reference to this Practice Note and the related engagement terms agreed between the listed issuer and the auditor. In this respect, the auditor should plan the engagement so that it will be performed effectively. The auditor should discuss with management the timing of the provision of the required information in order to allow sufficient time for the auditor to complete his work for the purpose of issuing his letter within the Stock Exchange's timeline.
17. The auditor should consider procedures performed during the course of the audit of the listed issuer's financial statements for the same period in respect of related party transactions, and considers the outcome of those procedures to the extent that they are relevant to his engagement to report on continuing connected transactions.
18. When carrying out his work with reference to this Practice Note, the auditor would carry out his work as a limited assurance engagement. The auditor should comply with the HKICPA's Code of Ethics for Professional Accountants and implement quality control procedures. The ethical requirements govern the auditor's professional responsibilities in the following areas: independence, integrity, objectivity, professional competence and due care, confidentiality, professional behavior, and technical standards. The elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and specific engagements, assignment of engagement teams, engagement performance, and monitoring.

19. The auditor reports on the continuing connected transactions that are disclosed in the annual report and should exercise his professional judgment as to the scope and extent of procedures necessary. Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38 contemplates that when reporting on continuing connected transactions the auditor issues a letter addressed to the listed issuer's board of directors.

## General considerations

### *Completeness of identification of connected persons and transactions*

20. Normally there are inherent limitations and a degree of uncertainty associated with assertions regarding the identification of all connected persons and completeness of transactions with connected persons. The procedures identified in this Practice Note will provide a sufficient appropriate basis for the auditor to issue the form of letter contemplated in this Practice Note in the absence of any circumstance identified by the auditor that:
- (a) increases the risk of material misstatement beyond that which would ordinarily be expected; or
  - (b) indicates that a material misstatement of disclosed continuing connected transactions has occurred.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.

21. An engagement performed with reference to this Practice Note cannot be expected to detect all continuing connected transactions.
22. The auditor's letter would include a paragraph explaining the inherent limitations of the auditor's work in determining whether the information provided by the directors in respect of continuing connected transactions includes all continuing connected transactions. Instead, the auditor's work covers those continuing connected transactions that have been identified by the directors. In this regard, the auditor would obtain the directors' written representations as to the completeness of the continuing connected transactions identified by the listed issuer.
23. Notwithstanding the inherent limitations typically encountered by auditors as to the completeness and identification of continuing connected transactions and the fact that auditors are not required by this Practice Note to confirm such matters, if an auditor becomes aware of any specific circumstances arousing suspicion that continuing connected transactions have not been identified or have been omitted from disclosure, whether deliberately or otherwise, the auditor assesses the implications and considers appropriate actions that he should take.
24. The auditor should give consideration to the listed issuer's internal controls in place to identify additional connected persons or additional connected transactions arising during the period, for example, due to acquisitions of new subsidiaries during the period or changes to the counterparties of the continuing connected transactions.
25. Main Board Listing Rule 14A.12A (2) / GEM Listing Rule 20.12A (2) states that the Stock Exchange will not normally treat a PRC Governmental Body (see definition in Main Board Listing Rule 19A.04 / GEM Listing Rule 25.04) as a connected person of a listed issuer. If requested by the Stock Exchange the listed issuer must make written representations to the Stock Exchange explaining its legal, commercial or other relationships with the PRC Governmental Body and must satisfy the Stock Exchange that it should not be treated as a connected person, or if the Stock Exchange determines that it should be treated as a connected person, the listed issuer must agree to comply with any additional obligations arising from such treatment as may be requested by the Stock Exchange. Therefore, where the listed issuer transacts with other PRC state-owned enterprises and the auditor has any concern as to whether the transactions should be regarded as continuing connected transactions, the auditor should confirm with the listed issuer the extent to which such transactions have been

determined by the Stock Exchange to constitute continuing connected transactions. The auditor should also consider obtaining management representations in this regard.

*Nature of the engagement to be performed*

26. Following discussions between the Stock Exchange, staff at the SFC, and the HKICPA, to satisfy the requirements of the Listing Rules, it is considered appropriate for the auditor to conduct a limited assurance engagement on the continuing connected transactions identified by the listed issuer with reference to this Practice Note. A limited assurance engagement, in contrast to an audit, is not designed to obtain reasonable assurance that the continuing connected transactions disclosed in the listed issuer's annual report are free from material misstatement. A limited assurance engagement consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. When carrying out an engagement under this Practice Note, in addition to making inquiries and performing analytical procedures, the auditor will typically test a sample of transactions.
27. As explained in paragraph 22 of this Practice Note, the auditor's letter on continuing connected transactions is ring-fenced to cover solely those continuing connected transactions that have been identified by management. As also explained in paragraph 23 of this Practice Note, the auditor remains alert for circumstances that may indicate that some continuing connected transactions may have been omitted from disclosure. For example, the auditor considers the connected persons identified by management in light of those disclosed in the relevant previous announcements. Where there are apparent omissions, the auditor inquires as to the reasons and considers management's response and the implications on the contents of his letter.
28. A limited assurance engagement may bring significant matters affecting the disclosed continuing connected transactions to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

*Terms of engagement*

29. The auditor and the listed issuer should agree on the terms of engagement.
30. It is in the interests of both the auditor and the listed issuer that the auditor's role in respect of issuing a letter on continuing connected transactions is set out in writing. This may be achieved in a number of ways, for example, by including relevant terms and conditions in the audit engagement letter or by agreeing the terms and conditions in a separate engagement letter that deals specifically with the auditor's reporting on continuing connected transactions.
31. Matters that may be dealt with in the engagement letter include:
  - (a) the objective of the engagement, namely to report on continuing connected transactions disclosed in the listed issuer's annual report;
  - (b) the scope of the engagement;
  - (c) the directors' responsibility for ensuring the completeness and accuracy of disclosures of continuing connected transactions in the listed issuer's annual report and for the listed issuer's compliance with the Listing Rules in respect of continuing connected transactions and relevant laws and regulations;
  - (d) the directors' responsibility for establishing and maintaining effective internal controls relevant to the identification, recording, authorization and reporting of all connected persons and connected transactions, including all continuing connected transactions;
  - (e) the directors' responsibility for making all books and accounts and related information available to the auditor;

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

- (f) the directors' agreement to provide written representations to the auditor in respect of continuing connected transactions that the auditor considers to be necessary;
- (g) the auditor's responsibilities including reference that the auditor will conduct a limited assurance engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to this Practice Note;
- (h) the anticipated form and content of the auditor's letter to be issued, including the identity of the addressee of the letter and any restrictions on distribution and disclosure of the letter, as well as any other matters that the auditor believes appropriate to include in the engagement letter; and
- (i) a statement explaining any inherent limitations of the auditor's work (for example, with respect to completeness of continuing connected transactions, as explained in paragraphs 20 - 25 above).

An illustrative engagement letter is set out in Appendix 3 to this Practice Note.

*Extent of testing and sampling*

- 32. The auditor's understanding of the entity and its environment, including its internal controls, the results of the risk assessments relating to the continuing connected transactions and the auditor's consideration of materiality as it relates to the continuing connected transactions, affects the nature and extent of the inquiries made, as well as the nature and extent of analytical and other procedures.
- 33. For the purpose of addressing the Listing Rules' requirements, the auditor will typically perform tests of a sample of transactions in addition to making inquiries and applying, where relevant, analytical procedures. The auditor decides which means or combination of means, to be used for the determination of the number of items for testing and the selection of items for testing, based on his assessment of the risk of material misstatement in the context of the nature of the engagement and the matters to be addressed in his letter.
- 34. The extent of testing and the selection of items for testing should be solely determined by the auditor.

*Materiality*

- 35. Materiality should be considered by the auditor when determining the nature, timing and extent of his procedures; and evaluating the effect of misstatements. A matter in respect of continuing connected transactions is material if its omission or misstatement could reasonably be expected to influence the decisions of the users of the information disclosed. Materiality is considered in the context of quantitative factors such as relative magnitude and qualitative factors. This would include considering the nature and extent of the effect of these factors on the evaluation or measurement of the continuing connected transactions, and the interests of, for example, minority shareholders (whose interests the Main Board Listing Rules Chapter 14A / GEM Listing Rules Chapter 20 is intended to help protect). The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the auditor's judgment.
- 36. For example, a misstatement in the value of continuing connected transactions may be small in terms of the amount. However, if adding the omitted amount to the amounts disclosed results in a breach of the maximum aggregate annual value (or cap) permitted for the relevant continuing connected transactions, the omission may be material.
- 37. In evaluating whether, on the basis of the work undertaken, anything has come to his attention that causes him to believe that the matters in respect of which he is required to report have not been complied with, in all material respects, the auditor should assess whether the misstatements aggregated by him during the engagement are material, both individually and in aggregate.



38. The auditor should consider the concept of materiality in relation to the continuing connected transactions being reported upon. Reporting on continuing connected transactions provides a smaller base against which to measure materiality compared with the financial statements taken as a whole. Consequently, the auditor's procedures will ordinarily be more extensive than if the same disclosures of continuing connected transactions were to be reviewed in connection with a limited assurance report on the entire financial statements.
39. If the auditor has identified a material misstatement, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance.
40. When undertaking his work, in some situations the auditor needs to evaluate the listed issuer's compliance with certain requirements that may not be expressed solely in numerical terms. For example, under Main Board Listing Rule 14A.38(2) / GEM Listing Rule 20.38(2) the auditor evaluates whether prices charged for goods or services delivered to connected persons are in accordance with the listed issuer's pricing policies, and under Main Board Listing Rule 14A.38(3) / GEM Listing Rule 20.38(3), the auditor evaluates whether the continuing connected transactions were entered into in accordance with the relevant agreements. Evaluating compliance with requirements that are not expressed in numerical terms, involves assessing qualitative and often subjective aspects, and for any area of non-compliance, the auditor needs to consider whether it is material and if so, the impact of such non-compliance on his conclusions. Where the auditor identifies areas of non-compliance in respect of these types of terms, for example if say, certain aspects of the price charged were not in compliance with the listed issuer's pricing policies, it may be useful for the auditor to quantify or estimate the financial impact that such non-compliance would have had on the value of the relevant transactions and then using that amount to evaluate whether the non-compliance is material individually or when aggregated with other misstatements, as described in paragraph 37 above.
41. The auditor's conclusions in his report are based on evaluating the matters in the context of what is material and whether anything has come to his attention that causes him to believe that the relevant requirements have not been complied with, in all material respects.

*Interaction with the annual audit*

42. During the course of the annual audit in accordance with HKSAs, the auditor is required to perform procedures in respect of related parties and transactions as set out in HKSA 550 "Related Parties". The definition of related party as set out in HKAS 24 and the definition of connected person in the Listing Rules are not the same. Nevertheless, many of the issues encountered when considering related party transactions during the course of the audit are broadly similar to those encountered in respect of continuing connected transactions. However, the respective reporting requirements for a listed issuer and its auditor in respect of continuing connected transactions under Main Board Listing Rules Chapter 14A / GEM Listing Rules Chapter 20 are different to those applicable for related party transactions in accordance with Hong Kong Financial Reporting Standards and the audit thereof under HKSAs.
43. The auditor should consider procedures performed and findings on related party transactions arising from his audit of the listed issuer's financial statements when designing, carrying out and evaluating the outcome of his procedures on the listed issuer's continuing connected transactions.

*Risks of fraud and error*

44. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:
  - (a) Omitting, advancing or delaying recognition of continuing connected transactions that have occurred during the reporting period;

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

- (b) Concealing, or not disclosing, facts that could affect the identification of connected persons and the amounts of disclosed continuing connected transactions;
  - (c) Altering records and terms related to significant and unusual continuing connected transactions.
45. The responsibility for the prevention and detection of fraud rests with both those charged with governance of the listed issuer and with management. It is the responsibility of those charged with governance of the listed issuer to ensure, through oversight of management, that the listed issuer establishes and maintains internal controls relevant to continuing connected transactions to provide reasonable assurance with regard to reliability of the disclosure of continuing connected transactions, effectiveness and efficiency of operations of those internal controls and compliance with applicable laws and regulations.
46. Due to the inherent limitations of an engagement performed in accordance with HKSAE 3000 and with reference to this Practice Note, there is an unavoidable risk that some material misstatements of continuing connected transactions will not be detected by the auditor. This is the case even though the engagement is properly planned and performed in accordance with HKSAE 3000 and with reference to this Practice Note.
47. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. These may include, for example, failure by management to disclose to the auditor connected relationships or concealing the true identities of counterparties. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to rely on evidence when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved.

*Skepticism*

48. The auditor should plan and perform the engagement to issue his letter on continuing connected transactions with an attitude of professional skepticism, recognizing that circumstances may exist that cause the information to require a material adjustment for it to be prepared and disclosed, in all material respects, in accordance with the applicable requirements of the Listing Rules. An attitude of professional skepticism means that the auditor makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by management of the listed issuer.

*Written representations*

49. The auditor should obtain representations. Ordinarily a written representation letter should be obtained from the listed issuer's directors confirming that:
- (a) the company has complied with the applicable reporting, approval and announcement requirements set out in the Listing Rules in respect of the continuing connected transactions;
  - (b) the company has appropriate internal controls over the identification, recording, authorization and reporting of all connected persons and connected transactions, including all continuing connected transactions;
  - (c) they are responsible for the design, implementation and maintenance of internal controls to prevent and detect fraud and error and have disclosed to the auditor the following:
    - their knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal controls; or others where the fraud could have a material effect on the books of accounts, records

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

and supporting documentation in respect of the entity's continuing connected transactions.

- their knowledge of any allegations of fraud or suspected frauds, affecting the entity's books of accounts, records and supporting documentation in respect of the entity's continuing connected transactions communicated by employees, former employees or others.
  - the results of their assessment of the risk that the books of accounts, records and supporting documentation in respect of the entity's continuing connected transactions may be materially misstated as a result of fraud.
- (d) they have made available to the auditor all books of accounts, records and supporting documentation in respect of the entity's continuing connected transactions.
- (e) they have disclosed to the auditor the identity of the entity's connected persons and all the connected relationships and transactions of which they are aware;
- (f) the continuing connected transactions disclosed in the listed issuer's annual report are complete and accurate;
- (g) the continuing connected transactions have been entered into in compliance with the applicable requirements of the Listing Rules;
- (h) the continuing connected transactions have received the approval of the listed issuer's board of directors;
- (i) the continuing connected transactions are in accordance with the pricing policies of the listed issuer where the transactions involve provision of goods or services by the listed issuer;
- (j) the relevant agreements governing the continuing connected transactions are in place and the continuing connected transactions have been entered into in accordance with the relevant agreements. No side agreement has been entered into in respect of any transaction, or if there are any side agreements, they have been made available to the auditor;
- (k) the continuing connected transactions have not exceeded the maximum aggregate annual value disclosed in previous announcements;
- (l) the independent non-executive directors have confirmed that the transactions have complied with the requirements of the Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37. Where the INEDs have not issued their confirmation prior to the auditor issuing his letter, the auditor should make inquiries as set out in paragraph 53 below; and
- (m) the directors believe the effects of those misstatements aggregated by the auditor during the engagement are immaterial, both individually and in the aggregate, and do not constitute non-compliance with the applicable requirements of the Listing Rules regarding continuing connected transactions. A summary of such misstatements should be included in or attached to the written representations.
50. The auditor may also request other representations where appropriate.
51. Representations by management cannot be a substitute for other evidence that the auditor could reasonably expect to be available. If a representation by management is contradicted by other evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

52. An example management representation letter in respect of reporting on continuing connected transactions is illustrated in Appendix 4 to this Practice Note.
53. Pursuant to Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38, a copy of the auditor's letter on continuing connected transactions should be provided by the listed issuer to the Stock Exchange not less than 10 business days prior to the bulk printing of the listed issuer's annual report. However, the INEDs' confirmation under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37 is not subject to the same reporting deadline. Therefore, situations can arise where the auditor may be requested to issue his letter on continuing connected transactions before the INEDs have completed their review under the Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37. In instances where the INEDs' confirmation has not been issued before the auditor's letter on continuing connected transactions is issued, the auditor makes inquiries of the INEDs (directly or through management) as to whether there are any matters in respect of those representations set out in paragraph 49(l) of this Practice Note identified to date by the INEDs during the course of their review of continuing connected transactions, and considers the implications. In addition, management should be requested to inform the auditor of the issues, if any, identified by the INEDs upon completion of their review and issue of their confirmation so that the auditor may consider the implications of such issues on his letter.

*Communication with those charged with governance*

54. Ordinarily, the auditor initially discusses matters of governance interest with management, except where those matters relate to questions of management competence or integrity. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.
55. In light of the INEDs' responsibility for reviewing the continuing connected transactions under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37, the auditor should consider discussing with the listed issuer's INEDs (directly or through management) the outcome from the INEDs' review of continuing connected transactions. Whilst the scope of the INEDs' review of continuing connected transactions is not the same as the auditor's scope of work, any issues identified by the INEDs may impact on the auditor's risk assessments and procedures. Similarly, any issues noted by the auditor during the course of his work may be of relevance to the INEDs, although the auditor's engagement to issue a letter on continuing connected transactions under this Practice Note is not intended to provide any basis for the INEDs' review and confirmation under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37. Where the auditor is requested to provide assistance to the INEDs in relation to the INEDs' obligations under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37, such assistance constitutes a separate engagement.
56. The auditor should also consider discussing with the listed issuer's internal auditor, Audit Committee and any other committee that is responsible for managing and reviewing connected transactions, details of significant matters arising during the engagement performed with reference to this Practice Note.
57. Communicating significant matters arising during an engagement performed in accordance with HKSAE 3000 and with reference to this Practice Note helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of those matters.
58. The auditor should inform those charged with governance of those misstatements aggregated by the auditor during the engagement that were determined by management to be immaterial, both individually and in the aggregate and that were determined by management not to constitute non-compliance with the applicable requirements of the Listing Rules regarding continuing connected transactions.

59. Where appropriate, the auditor may also wish to draw the INEDs' and Audit Committee's attention to the nature of his engagement, the inherent limitations of his work regarding completeness of continuing connected transactions in addition to any other significant matters.
60. The auditor is not required, when carrying out an engagement with reference to this Practice Note, to design procedures for the specific purpose of identifying matters of governance interest. However, during the course of the engagement, the auditor may note weaknesses or breakdowns in internal controls or other matters which he considers to be material and which he considers should be brought to the attention of those charged with governance. These may include, for example, fraud or material errors or non-compliance with laws and regulations. The auditor should also consider their impact on the engagement. Where appropriate, the auditor may provide recommendations for improvement. Examples of significant matters in respect of continuing connected transactions include:
- (a) non-disclosure (whether intentional or not) by management to the auditor of connected persons or significant connected transactions, which may alert those charged with governance to significant connected relationships and transactions of which they may not have been previously aware;
  - (b) the identification of significant connected transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud;
  - (c) non-compliance with the applicable requirements of the Listing Rules regarding connected transactions of which the auditor has become aware.

### **Specific considerations**

61. Under Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38, when the listed issuer engages the auditor to report on continuing connected transactions, the auditor is requested to issue a letter to the listed issuer's board of directors (with a copy to be provided to the Stock Exchange at least 10 business days prior to the bulk printing of the listed issuer's annual report) reporting as to whether the continuing connected transactions:
- (a) have received the approval of the listed issuer's board of directors;
  - (b) are in accordance with the pricing policies of the listed issuer if the transactions involve provision of goods or services by the listed issuer;
  - (c) have been entered into in accordance with the relevant agreement governing the transactions; and
  - (d) have not exceeded the caps disclosed in previous announcements.

Some of the foregoing provisions may be interpreted widely. The auditor's normal response and approach when issuing his letter on these matters in accordance with HKSAE 3000 and with reference to this Practice Note are set out below.

#### *Reporting on approval by directors*

62. Main Board Listing Rule 14A.38(1) / GEM Listing Rule 20.38(1) requires that the auditor's letter should report on whether the continuing connected transactions have received the approval of the listed issuer's board of directors.
63. The auditor should obtain appropriate and sufficient evidence that the continuing connected transactions have been formally approved by the listed issuer's board of directors, for example, by inspecting minutes of meetings of the board of directors, or by obtaining written representations issued on behalf of the board or other suitable evidence of approval.

*Reporting as to whether transactions complied with the listed issuer's pricing policies*

64. Where the listed issuer provides goods or services to a connected person, Main Board Listing Rule 14A.38(2) / GEM Listing Rule 20.38(2) requires that the auditor's letter should report on whether such continuing connected transactions are in accordance with the pricing policies of the listed issuer. This reporting requirement does not apply in respect of goods / services received by the listed issuer from connected persons.
65. The auditor should make inquiries of management as to whether the continuing connected transactions have complied with the listed issuer's pricing policies. Where management confirms that some or all transactions have not complied with the listed issuer's pricing policies, the auditor should consider the impact on his work and letter. The auditor also considers whether the matter should be discussed with those charged with governance and whether the listed issuer should discuss the non-compliance with the Stock Exchange.
66. In addition to the inquiries described in paragraph 65 above, the auditor's other procedures when considering whether the relevant continuing connected transactions are in accordance with the listed issuer's pricing policies may vary according to the pricing terms of the relevant agreement. This will normally include testing a sample of transactions.
67. Ordinarily for the sample selected, the auditor evaluates (i) whether the price charged for each transaction agrees to the price set out in the relevant agreement and in turn, (ii) whether the price set out in the agreement has been determined in accordance with the listed issuer's pricing policies.
68. Where an agreement or pricing policy contains clear and quantitative pricing terms specifying a standard unit price or standard range of unit prices for the continuing connected transactions, the auditor may compare the price of a sample of transactions against the quantitative pricing terms stated in the agreement or the pricing policy to evaluate whether the actual price charged was in agreement with the pricing terms stated in the relevant document(s).
69. However, difficulties may arise where the relevant agreement and / or pricing policy contains a pricing term which is qualitative or judgmental (for example, if any reference to the price to be charged indicates reference to "market value", "reasonableness" or "arm's length"). There may be insufficient objective criteria for the auditor to evaluate compliance with a qualitative or judgmental pricing term particularly where the relevant goods or services are not of a standard or uniform nature.
70. Although information may be available to indicate how the price of a continuing connected transaction compares to that of a similar transaction with an independent third party, there are ordinarily practical difficulties that limit the auditor's ability to obtain information that all aspects of a connected transaction are equivalent to those undertaken by the listed issuer with an independent third party.
71. Where the pricing terms are not clearly set out in the agreements and / or pricing policy governing the selected continuing connected transactions, the auditor should request management to provide details of comparable transactions undertaken with non-connected persons and seek to establish whether the price charged is consistent with the price charged for comparable transactions as identified by management and in turn how the price charged complies with the relevant agreement and / or the listed issuer's pricing policy. The auditor then reports based on a comparison of the prices charged in respect of the relevant continuing connected transactions with such comparable transactions.
72. When evaluating compliance with the listed issuer's pricing policies, the auditor considers making inquiries of management to understand the factors that have been considered by management in developing and setting the prices, such as the size of purchase, credit term periods and settlement methods and to consider how the approach adopted for setting the prices for the selected continuing connected transactions is consistent with the listed issuer's pricing policies.

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

73. There may be situations where the pricing term in the relevant agreement or pricing policy is unclear or qualitative or judgmental. For these situations, the auditor may choose to set his expectation of an appropriate price or a range of prices based on the relevant information available in the market and to then compare the expected price against the actual price charged.
74. If the actual price charged for the transaction is in line with the price estimated by the auditor or falls within the expected range of prices, the price would generally be taken as being in accordance with the listed issuer's pricing policies and the relevant agreement. If the actual price charged is different to the expected price or falls outside the expected range of prices, the auditor evaluates whether the difference can be accepted without further investigation. If not, the auditor carries out further investigation to evaluate whether the difference is due to:
- (a) differences in estimates made by the auditor, in which case the auditor reconsiders his expectation and whether it should be revised by taking into account management's explanation,
  - (b) error in the price charged, in which case the auditor quantifies and includes the error in a summary of misstatements and evaluates it as described in paragraph 37 of this Practice Note, or
  - (c) other reasons, in which case if management is unable to provide a reasonable and valid explanation for the difference or management's explanation cannot be corroborated, the auditor considers whether this may be indicative of fraud or error and / or whether further investigation and additional procedures are required.
75. The investigation carried out by the auditor ordinarily begins with inquiries of management, followed by corroboration of management's responses, for example, by comparing them with the auditor's understanding of the listed issuer and other evidence obtained during the course of the engagement; and consideration of the need to apply other procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.
76. If the auditor is unable to reach a conclusion after conducting the work with reference to the guidance set out in paragraph 64 to 75 above, he should consider the impact on his letter and should discuss with the listed issuer's management and consider the guidance in paragraphs 97 and 99 below.
77. Under Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37, it is the INEDs' responsibility (and not that of the auditor) to confirm that the continuing connected transactions were entered into on normal commercial terms, or on terms no less favorable to the listed issuer than terms available to or from independent third parties. Whilst the auditor is not required to conclude or comment on whether or not the continuing connected transactions have been entered into on normal commercial terms or on no less favorable terms than those with independent third parties, the auditor should consider discussing with the INEDs (directly or through management) to consider the INEDs' work and any issues that the INEDs identified during their annual review of continuing connected transactions.
78. The auditor's conclusions as to whether anything has come to his attention that causes him to believe that transactions involving the provision of goods or services were not in accordance with the listed issuer's pricing policies, are drawn in the context of primarily evaluating matters in respect of prices charged and evaluating compliance with the listed issuer's pricing policies in light of the guidance set out in paragraphs 64 to 77 above.

*Reporting as to whether transactions were entered into in accordance with the relevant agreement*

79. Main Board Listing Rule 14A.38(3) / GEM Listing Rule 20.38(3) requires an auditor's letter to report on whether the continuing connected transactions have been entered into in accordance with the relevant agreement governing the transactions.

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

80. Main Board Listing Rule 14A.35 / GEM Listing Rule 20.35, requires that when a listed issuer enters into a continuing connected transaction not falling under the exemption in Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, it must, in respect of each connected transaction, enter into a written agreement(s) with the connected person. The agreement must set out the basis of the calculation of the payments to be made and the period must be fixed and reflect normal commercial terms and, except in special circumstances, must not exceed three years.
81. Depending on the nature of the connected transaction, the relevant agreement governing the transaction may include many terms and conditions to be fulfilled by the parties to the agreement.
82. Some of these, in turn, may need to be fulfilled at different stages as specified in the agreement. It may be difficult for the auditor to assess whether all obligations and terms in the related agreement have been fulfilled. Furthermore, in the case of compliance with technical specifications set out in the relevant agreement that are applicable to a product or service, the auditor may not have sufficient expertise to evaluate whether the technical specifications have been adhered to or, if not, the significance of any non-compliance.
83. The auditor will ordinarily focus his work on confirming with management whether there is an agreement in place governing the continuing connected transactions and whether the actual price charged for the transaction was in line with the pricing terms set out in the agreement. Although paragraphs 64 to 78 deal with prices of goods and services in respect of continuing connected transactions provided by the listed issuer, similar guidance would typically apply when considering whether the price charged for goods and services received by the listed issuer was in accordance with the pricing terms set out in the relevant agreements. Where appropriate, the auditor may consider inquiring of personnel other than those responsible for financial and accounting matters in respect of any non-compliance with technical specifications set out in the relevant agreement, for example, with management responsible for production or engineering staff in the case of technical specifications.
84. The auditor should consider inspecting a sample of transactions to establish whether there is an agreement in place with the connected person with a fixed period and whether the acceptance of delivery of goods or services was supported by documentary evidence. When doing so, the auditor's objective is to obtain prima facie evidence in support of management's representation, but not for the purpose of confirming or reporting on compliance with all contractual matters. In respect of the transactions tested, the principal objective is to consider whether the transactions tested were covered by the agreement and that the relevant good/service envisaged by the agreement was exchanged at the agreed price.
85. For example, if the continuing connected transaction is to sell stainless steel components to the connected person, the auditor may not generally have the level of engineering or technical expertise to identify whether the particular product provided was fully compliant with technical requirements in the relevant agreement if the invoices indicated that "steel components" (rather than stainless steel components) were delivered.
86. For the purpose of an engagement under this Practice Note, it is generally regarded as a reasonable assumption that the right goods / services were delivered if the delivery is supported by a signed delivery note or other written acknowledgement of receipt of the goods / services being in accordance with the relevant agreement. Where such documentary evidence is not available, the auditor considers whether this may indicate non-compliance with the relevant agreement and where he considers necessary, discusses further with management and assesses the implications on the matters to be set out in his letter. However, the absence of documentary evidence does not necessarily mean that the auditor concludes that there has been any non-compliance.
87. In addition, for samples tested, the auditor compares the price of a sample of continuing connected transactions against the quantitative pricing term stated in the agreement to evaluate whether the actual price charged was in agreement with the pricing term stated in the agreement. In instances where the pricing term is qualitative or judgmental, guidance set out in paragraphs 68 to 71 and 73 to 75 relating to assessing whether the price charged was in accordance with the pricing terms set out in the relevant agreements would also apply.



88. The auditor should also confirm with management that no side agreements have been entered into in respect of the continuing connected transactions which have not been made available to the auditor.
89. The auditor's conclusions in his report are primarily based on evaluating whether anything has come to his attention that causes him to believe that there was not an agreement in place governing the transactions and that the prices charged were not, in all material respects, in accordance with the pricing terms set out in the relevant agreements governing such transactions, in light of the guidance set out in paragraphs 79 to 88 above.

*Reporting on whether transactions are within the maximum aggregate annual amount ("cap")*

90. Main Board Listing Rule 14A.38(4) / GEM Listing Rule 20.38(4) requires the auditor's letter to report on whether the continuing connected transactions have not exceeded the cap disclosed in previous announcements made by the listed issuer.
91. The auditor should make inquiries of management to confirm that the continuing connected transactions have not exceeded the relevant cap(s).
92. In addition, the auditor should compare the aggregate amounts of the continuing connected transactions to the respective cap. When doing so, the auditor should confirm with management the relevant previous announcements to confirm the amount of the cap.
93. The auditor should compare the different types of continuing connected transactions disclosed in the relevant previous announcements to those disclosed in the annual report. Where there are apparent omissions from disclosure, the auditor should make inquiries of management and satisfy himself as to the reasons for any apparent omissions (for example, it could be the case that the listed issuer did not subsequently enter into transactions that were originally contemplated).

## **Reporting**

*General aspects*

94. The auditor should evaluate the results of his procedures in order to form the conclusions in his letter.
95. The auditor's letter is addressed to the listed issuer's board of directors and includes conclusions on the basis of the work undertaken in accordance with HKSAE 3000 and with reference to this Practice Note.
96. The auditor should consider the impact of any matters identified on his work and letter. For example, the auditor should consider whether any matters would preclude the auditor from issuing his letter or whether he may need to modify or qualify any conclusions.
97. The auditor should also consider whether the matter(s) should be discussed with management and / or those charged with governance, and whether the listed issuer should discuss such with the Stock Exchange. For example, the following matters should be considered:
  - (a) where the actual price charged of some or all continuing connected transactions was not in agreement with the pricing terms stated in the relevant agreement or the pricing policy of the listed issuer;
  - (b) where the actual price charged of some or all continuing connected transactions was not consistent with the price charged for comparable transactions as identified by management; or
  - (c) where the approach adopted by the listed issuer for setting prices for some or all continuing connected transactions was inconsistent with the approach adopted for other transactions.

98. An example unmodified auditor's letter on continuing connected transactions is set out in Appendix 2 to this Practice Note. However circumstances may arise where the auditor believes that a modified or qualified conclusion is appropriate. This Practice Note does not preclude the auditor from issuing a modified or qualified conclusion.
99. Under the Main Board Listing Rule 14A.40 / GEM Listing Rule 20.40, a listed issuer is required to promptly notify the Stock Exchange and publish an announcement if it knows or has reason to believe that the INEDs and / or the auditor will not be able to confirm the matters set out in the Main Board Listing Rules 14A.37 and / or 14A.38 or GEM Listing Rules 20.37 and / or 20.38 respectively. In this respect, reference to the auditor not being able to confirm the matters set out in the Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38 should be evaluated as to whether the auditor would not be able to issue an unmodified letter as envisaged in this Practice Note. The responsibility for determining whether any announcement is required rests solely with the listed issuer's directors. Where a directors' meeting of the listed issuer to approve the management representation letter in respect of the auditor's letter is required to be held, but is scheduled to take place less than 10 business days prior to the bulk printing of the listed issuer's annual report, the auditor may not be able to issue his letter in final form to enable the listed issuer to provide a copy to the Stock Exchange within the Stock Exchange's timeframe. In these circumstances, the listed issuer should consider communicating the potential delay and its best estimate of the expected delivery date of the auditor's letter to the Stock Exchange in writing.
100. The auditor should note that the listed issuer is required to provide a copy of the auditor's letter in respect of continuing connected transactions to the Stock Exchange pursuant to the Listing Rules. In the auditor's letter, the auditor should give his express consent to the letter being supplied to the Stock Exchange.
101. Once the auditor's letter is issued, the auditor has no further direct responsibility to update or actively seek information on events occurring subsequent to the date of the letter. The listed issuer should be requested to inform the auditor of any event occurring subsequent to the date of the auditor's letter that may impact on the letter, prior to the issuance of the listed issuer's annual report. For example, in instances where the INEDs' confirmation has not been issued before the auditor's letter on continuing connected transactions is issued, management should be requested to inform the auditor of the issues, if any, identified by the INEDs upon completion of their review and issue of their confirmation, so that the auditor may consider the implications of such issues on his letter.

*References to auditor's letter in the annual report*

102. The Main Board Listing Rule 14A.39 / GEM Listing Rule 20.39 requires that the listed issuer's board of directors must state in the annual report whether its auditor has confirmed the matters stated in the Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38. In this respect, given the nature of the engagement and for better clarity as to the work performed with reference to this Practice Note, generally a suitable disclosure in this respect would be for the listed issuer to include appropriate references in the annual report to the work performed by the auditor. In instances where the auditor's letter is proposed to be modified or qualified, the auditor should remind the listed issuer's directors of their obligations under Main Board Listing Rule 14A.40 / GEM Listing Rule 20.40 to promptly notify the Stock Exchange and to issue an announcement concerning the modification or qualification. Details of the modification or qualification should be disclosed in the annual report. An illustrative example of such a disclosure in instances where the auditor's letter issued does not contain any modification or qualification is set out below.

*"The Company's auditor was engaged to report on the Group's continuing connected transactions in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants. The auditor has issued his unqualified letter containing his findings and conclusions in respect of the continuing connected transactions disclosed by the Group in page [ ] of the Annual Report in accordance with*

*[Main Board Listing Rule 14A.38][GEM Listing Rule 20.38]. A copy of the auditor's letter has been provided by the Company to The Stock Exchange of Hong Kong Limited.]*

103. The Main Board Listing Rules 14A.45 and 14A.46 / GEM Listing Rules 20.45 and 20.46 require the listed issuer to disclose the particulars of the continuing connected transactions in its next published annual report and accounts and its subsequent published annual report and accounts for the financial years during which the listed issuer undertakes the continuing connected transactions under the written agreement entered into pursuant to the Main Board Listing Rule 14A.35(1) / GEM Listing Rule 20.35(1). The auditor should consider whether the disclosures in the annual report are consistent with the information and findings in respect of the continuing connected transactions on which the auditor reports.
104. Whilst any disclosures in the annual report are solely the responsibility of the listed issuer's directors, where the auditor considers that any inappropriate references have been made in respect of his work or conclusions or any incorrect disclosures have been made in respect of the continuing connected transactions, he should discuss with management and if he feels it necessary, with those charged with governance. The auditor's response will depend on the nature of any issue and his view on the extent to which he considers that any reference to him or his work are inappropriate.

## **Documentation**

105. The auditor should prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's conclusions and to provide evidence that the engagement was performed in accordance with HKSAE 3000 and with reference to this Practice Note. The documentation enables an experienced auditor having no previous connection with the engagement to understand the nature, timing and extent of the inquiries made, and analytical and other procedures applied, information obtained, and any significant matters considered during the performance of the engagement, including the disposition of such matters.

## **Effective date**

106. This Practice Note is effective for reporting on continuing connected transactions disclosed in annual reports for periods ending on or after 31 December 2010. Earlier adoption of the Practice Note is permissible.

## Appendix 1

### Summary of relevant Main Board Listing Rules and GEM Listing Rules

Below is a summary of Main Board Listing Rules and GEM Listing Rules that we have referred to in the body of this Practice Note and that are effective at the issuance of this Practice Note. This summary is broadly replicated from the Main Board Listing Rules. Although GEM Listing Rules are broadly aligned to Main Board Listing Rules, there may be slight differences between them which should be clear from the summary below.

In all cases, auditors should refer to Chapter 1, 14A and 19 of Main Board Listing Rules / Chapter 1, 20 and 25 of GEM Listing Rules for the original rules in respect of connected transactions, and which The Stock Exchange of Hong Kong Limited may update from time to time.

Main Board  
Listing Rule /  
GEM Listing  
Rule

1.01 / 1.01 Throughout this book, the following terms, save where the context otherwise requires, have the following meanings:

.....

- “connected person”** (a) in relation to a company other than a PRC issuer, and other than any subsidiaries of a PRC issuer, means a director, chief executive or substantial shareholder of such company or any of its subsidiaries or an associate of any of them; and
- [GEM Listing Rule 1.01 refers to two terms **“person connected”** and **“connected person”** both of which have the same definition in GEM Listing Rules] (b) in relation to a PRC issuer means a director, supervisor, chief executive or substantial shareholder of the PRC issuer or any of its subsidiaries or an associate of any of them

Main Board Listing  
Rules

*Note: This definition is modified in the case of Chapter 14A only by the provisions of Main Board Listing Rules 14A.11, 14A.12 and 14A.12A.*

GEM Listing Rules

*Note: This definition is modified for the purposes of Chapter 20 by virtue of the provisions of GEM Listing Rules 20.11, 20.12 and 20.12A*

.....

#### General matters concerning definitions and interpretation

14A.10 / 20.10 In this Chapter:

.....

- (8) “normal commercial terms” are terms which a party could obtain if the transaction were on arm’s length basis or on terms no less favourable to the listed issuer than terms available to or from independent third parties;

.....

### Definition of connected person

14A.11 / 20.11 Main Board Listing Rule 1.01 / GEM Listing Rule 1.01 contains a general definition of “connected person”. In this Chapter, the definition of “connected person” includes:

- (1) a director, chief executive or substantial shareholder of the listed issuer;
- (2) any person who was a director of the listed issuer within the preceding 12 months;
- (3) a supervisor of a PRC issuer;
- (4) any associate of a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3). The definitions of “associate” (in the context of non-PRC issuers and PRC issuers) are contained in Main Board Listing Rules 1.01 and 19A.04 / GEM Listing Rules 1.01 and 25.04, respectively. In this Chapter, an “associate” of a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3) includes the following additional persons:
  - (a) any person or entity with whom a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3) has entered, or proposes to enter, into any agreement, arrangement, understanding or undertaking, whether formal or informal and whether express or implied, with respect to the transaction which is such that, in the opinion of the Exchange, that person or entity should be considered a connected person;
  - (b) (i) any person cohabiting as a spouse with, and any child, step-child, parent, step-parent, brother, sister, step-brother and step-sister of, a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3); and  
(ii) a company which the party referred to in Main Board Listing Rule 14A.11(4)(b)(i) / GEM Listing Rule 20.11(4)(b)(i) can exercise or control the exercise of more than 50% of the voting power at general meetings or control the composition of a majority of the board of directors; and
  - (c) (i) a father-in-law, mother-in-law, son-in-law, daughter-in-law, grandparent, grandchild, uncle, aunt, cousin, brother-in-law, sister-in-law, nephew and niece of a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3); and  
(ii) a company which the party referred to in Main Board Listing Rule 14A.11(4)(c)(i) / GEM Listing Rule 20.11(4)(c)(i) can exercise or control the exercise of more than 50% of the voting power at general meetings or control the composition of a majority of the board of directors.

whose association with the person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3) is such that, in the opinion of the Exchange, the proposed transaction should be subject to the requirements of this Chapter. Listed issuers must notify the Exchange of any proposed transaction with these parties unless the transaction is exempt under Main Board Listing Rules 14A.31 or 14A.33 / GEM Listing Rules 20.31 or 20.33. Listed issuers must also provide information to the Exchange to demonstrate whether or not these parties should be regarded as associates of the person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3);

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

Notes: 1. *A company which is an "associate" of a person referred to in Main Board Listing Rules 14A.11(1), (2) or (3) / GEM Listing Rules 20.11(1), (2) or (3) only because that person has an indirect interest in the company through its shareholding in the listed issuer is not a connected person.*

2. *[Repealed 3 June 2010]*

3. *For the purpose of Main Board Listing Rules 14A.11(4)(b)(ii) and 14A.11(4)(c)(ii) / GEM Listing Rules 20.11(4)(b)(ii) and 20.11(4)(c)(ii) , the Exchange may aggregate the interests of a person referred to in Main Board Listing Rule 14A. 11(1), (2) or (3) / GEM Listing Rule 20.11(1), (2) or (3) and his relatives in a company to determine whether they together have a majority control over the company.*

(5) any non wholly-owned subsidiary of the listed issuer where any connected person(s) of the listed issuer (other than at the level of its subsidiaries) as defined under Main Board Listing Rules 14A.11(1) to (4) / GEM Listing Rules 20.11(1) to (4) is/are (individually or together) entitled to exercise, or control the exercise of, 10% or more of the voting power at any general meeting of such non wholly-owned subsidiary; and

Notes: 1. *[Repealed 3 June 2010]*

2. *An interest of a connected person of the listed issuer (other than at the level of its subsidiaries) in the subsidiary which is held through the listed issuer is to be excluded from the 10% referred to in this rule.*

(6) any subsidiary of a non wholly-owned subsidiary referred to in Main Board Listing Rule 14A.11(5) / GEM Listing Rule 20.11(5).

14A.12A / 20.12A For the purpose of this Chapter,

(1) a non wholly-owned subsidiary will not be regarded as a connected person by virtue of being:

(a) a substantial shareholder of another subsidiary; or

(b) an associate of any connected persons (at the level of the issuer's subsidiaries only) as defined in Main Board Listing Rules 14A.11(1) to (3) / GEM Listing Rules 20.11(1) to (3); and

(2) the Exchange will not normally treat a PRC Governmental Body (see definition in Main Board Listing Rule 19A.04 / GEM Listing Rule 25.04) as a connected person of a listed issuer. If requested by the Exchange the issuer must make written representations to the Exchange explaining its legal, commercial or other relationships with the PRC Governmental Body and must satisfy the Exchange that it should not be treated as a connected person, or if the Exchange determines that it should be treated as connected person, the issuer must agree to comply with any additional obligations arising from such treatment as may be requested by the Exchange.

14A.12 / 20.12 The definition of "connected person" in Main Board Listing Rule 14A.11 / GEM Listing Rule 20.11 does not include any wholly-owned subsidiaries of the company whose securities are listed on the Exchange, whether directly or indirectly held.

### Definition of connected transaction

14A.13 / 20.13 A connected transaction is:

- (1) (a) any transaction between a listed issuer and a connected person; or

*Acquisition or disposal of interest in a company*

- (b) (i) any transaction between a listed issuer and a person who is not a connected person and the transaction involves the listed issuer acquiring or disposing of an interest in a company where a substantial shareholder of that company is, or is proposed to be, a controller or is (or will become as a result of the transaction) an associate of a controller. The Exchange may aggregate the interests of any person and his associates (as defined in Main Board Listing Rule 14A.11(4) / GEM Listing Rule 20.11(4)) in determining whether together they are a "substantial shareholder" of any company. Where assets (as opposed to businesses) account for 90% or more of such a company's net assets or total assets, the Exchange will treat the acquisition or disposal of such assets as a connected transaction and an acquisition or disposal of an interest in that company; or

*Notes: 1. A listed issuer itself will not be considered an "associate" of a controller when the listed issuer is acquiring or disposing of an interest in a company of which it is already a substantial shareholder.*

*2. A controller whose only interest in a company is through its interest in the listed issuer will not be taken to be a "substantial shareholder" of that company.*

*3. This rule does not apply where all the following conditions are met:*

*(i) the listed issuer acquires an interest in a company;*

*(ii) the substantial shareholder of the company being acquired is a director, chief executive or controlling shareholder of the company being acquired (or an associate of such director, chief executive or controlling shareholder) immediately prior to the acquisition;*

*(iii) it is proposed that the substantial shareholder will remain a director, chief executive or controlling shareholder of the company being acquired (or an associate of such director, chief executive or controlling shareholder) following the acquisition; and*

*(iv) following the acquisition, the only reason why he is still a controller is that he remains a director, chief executive or controlling shareholder of the company being acquired (or an associate of such director, chief executive or controlling shareholder), as the case may be. Where he remains a controlling shareholder, there must not be any increase in his interest in such company as a result of the acquisition.*

4. *For a disposal of interest in a company, this rule does not apply if (i) the disposal falls within this rule only because the substantial shareholder of the company being disposed of is a director, chief executive or controlling shareholder of this company (or an associate of such director, chief executive or controlling shareholder) immediately prior to the disposal; and (ii) there is no change in the substantial shareholder's interest in such company as a result of the disposal or any related arrangement.*

(ii) any transaction between a listed issuer and a person who is not a connected person and the transaction involves the listed issuer acquiring an interest in a company (or an option to acquire such interest) of which a controller (or an associate of a controller) is, or will become, a shareholder where the interest being acquired is:

(A) of a fixed income nature;

(B) shares to be acquired on less favourable terms than those granted to the controller or its associate; or

(C) shares which are of a different class from those held by, or to be granted to, the controller or its associate.

*Note: This rule does not apply where the acquisition is pursuant to the terms of a subscription of shares in the company by the listed issuer and the controller (or its associate) and the subscription upon such terms has previously been approved by shareholders in accordance with the requirements of this Chapter.*

*Subscription on favourable terms*

(iii) any transaction between a listed issuer and a person who is not a connected person and the transaction involves a controller (or an associate of a controller) subscribing on specially favourable terms shares in a company in which the listed issuer is a shareholder; or

*Note: This rule does not apply where the subscription is pursuant to the terms of a subscription of shares in the company by the listed issuer and the controller (or its associate) and the subscription upon such terms has previously been approved by shareholders in accordance with the requirements of this Chapter.*

*Subscription of different class of shares*

(iv) any transaction between a listed issuer and a person who is not a connected person and the transaction involves a controller (or an associate of a controller) subscribing shares in a company in which the listed issuer is a shareholder but which are of a different class from those held by the listed issuer.

*Note: This rule does not apply where the subscription is pursuant to the terms of a subscription of shares in the company by the listed issuer and the controller (or its associate) and the subscription upon such terms has previously been approved by shareholders in accordance with the requirements of this Chapter.*



*Financial assistance*

- (2) the provision of financial assistance:
- (a) by a listed issuer to:
- (i) a connected person; or
  - (ii) a company in which both the listed issuer and a connected person are shareholders and where any connected person(s) of the listed issuer (other than at the level of its subsidiaries) as defined under Main Board Listing Rules 14A.11(1) to (4) / GEM Listing Rules 20.11(1) to (4) is/are (individually or together) entitled to exercise, or control the exercise of, 10% or more of the voting power at any general meeting of such company; or

*Note: An interest of a connected person of the listed issuer (other than at the level of its subsidiaries) in the company which is held through the listed issuer is to be excluded from the 10% referred to in this rule.*

- (b) to a listed issuer by:
- (i) a connected person; or
  - (ii) a company in which both the listed issuer and a connected person are shareholders and where any connected person(s) of the listed issuer (other than at the level of its subsidiaries) as defined under Main Board Listing Rules 14A.11(1) to (4) / GEM Listing Rules 20.11(1) to (4) is/are (individually or together) entitled to exercise, or control the exercise of, 10% or more of the voting power at any general meeting of such company.

*Note: An interest of a connected person of the listed issuer (other than at the level of its subsidiaries) in the company which is held through the listed issuer is to be excluded from the 10% referred to in this rule.*

- (3) a listed issuer granting an indemnity or guarantee or providing financial assistance to and/or for the benefit of a connected person or any company falling under Main Board Listing Rule 14A.13(2)(a)(ii) / GEM Listing Rule 20.13(2)(a)(ii);
- (4) the granting of security over the assets of a listed issuer in respect of any financial assistance made to the listed issuer by a connected person or any company falling under Main Board Listing Rule 14A.13(2)(b)(ii) / GEM Listing Rule 20.13(2)(b)(ii).

Financial assistance transactions are governed by Main Board Listing Rules 14A.63 to 14A.66 / GEM Listing Rules 20.63 to 20.66;

*Options*

- (5) the writing, acceptance, transfer, exercise or non-exercise of an option (as defined in Main Board Listing Rule 14.72 / GEM Listing Rule 19.72) involving a listed issuer and a connected person. Options are governed by Main Board Listing Rules 14A.67 to 14A.71 / GEM Listing Rules 20.67 to 20.71; and

*Joint ventures*

- (6) the entering into of any arrangement or agreement involving the formation of a joint venture entity in any form, such as a partnership or a company, or any other form of joint arrangement by a listed issuer and a connected person (see Main Board Listing Rule 14A.10(13)(f) / GEM Listing Rule 20.10(13)(f)). Qualified Property Acquisition undertaken on a joint venture basis with a Qualified Connected Person is governed by Main Board Listing Rules 14A.72 to 14A.79 / GEM Listing Rules 20.72 to 20.79. In this case, the size of a listed issuer's financial commitment will be calculated in the manner set out in Main Board Listing Rule 14.15(2) / GEM Listing Rule 19.15(2).

**Definition of continuing connected transaction**

- 14A.14 / 20.14 Continuing connected transactions are connected transactions involving the provision of goods or services or financial assistance, which are carried out on a continuing or recurring basis and are expected to extend over a period of time. They are usually transactions in the ordinary and usual course of business of the issuer.
- 14A.15 / 20.15 Continuing connected transactions are governed by Main Board Listing Rules 14A.33 to 14A.41 / GEM Listing Rules 20.33 to 20.41.

**Continuing connected transactions  
exempt from the reporting, annual review, announcement and  
independent shareholders' approval requirements**

- 14A.33 / 20.33 The following continuing connected transactions will be exempt from the reporting, annual review, announcement and independent shareholders' approval requirements of this Chapter:

*Consumer goods or consumer services*

- (1) the provision of consumer goods or consumer services as set out in Main Board Listing Rule 14A.31(7) / GEM Listing Rule 20.31(7);

*Sharing of administrative services*

- (2) the sharing of administrative services as set out in Main Board Listing Rule 14A.31(8) / GEM Listing Rule 20.31(8);

*De minimis transactions*

- (3) a continuing connected transaction on normal commercial terms where each or all of the percentage ratios (other than the profits ratio) is/are on an annual basis:
- (a) less than 0.1%;
  - (b) less than 1% and the transaction is a connected transaction only because it involves a person who is a connected person of the issuer by virtue of its/his relationship(s) with the issuer's subsidiary or subsidiaries; or
  - (c) less than 5% and the annual consideration is less than HK\$1,000,000;

*Transactions with persons connected at the level of subsidiaries*

- (4) a continuing connected transaction that meets the requirements in Main Board Listing Rule 14A.31(9) / GEM Listing Rule 20.31(9); and

*Transactions with associates of a passive investor*

- (5) a continuing connected transaction that meets the requirements in Main Board Listing Rule 14A.31(10) / GEM Listing Rule 20.31(10).

Notes: 1. *When a connected person no longer meets the conditions under Main Board Listing Rule 14A.33(4) or 14A.33(5) / GEM Listing Rule 20.33(4) or 20.33(5), the issuer must, subject to Note 2 to Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, comply with all applicable reporting, annual review, announcement and independent shareholders' approval requirements for its subsequent continuing connected transactions with the connected person.*

2. *If the connected person no longer meets the conditions under Main Board Listing Rule 14A.33(4) or 14A.33(5) / GEM Listing Rule 20.33(4) or 20.33(5) during the term of an agreement for continuing connected transactions, the issuer is only required to comply with the applicable reporting, annual review and announcement requirements if:*

*(a) the agreement is for a fixed period with fixed terms; and*

*(b) the exemption under Main Board Listing Rule 14A.33(4) or 14A.33(5) / GEM Listing Rule 20.33(4) or 20.33(5) applies at the time of the agreement.*

*Issuers are encouraged to consult the Exchange on the application of this Note.*

**Non-exempt continuing connected transactions**

14A.35 / 20.35 When an issuer enters into a continuing connected transaction not falling under Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, it must:

- (1) in respect of each connected transaction, enter into written agreement(s) with the connected person. The agreement must set out the basis of the calculation of the payments to be made. The period for the agreement must be fixed and reflect normal commercial terms and, except in special circumstances, must not exceed 3 years. Special circumstances are limited to cases where the nature of the transaction requires the contract to be of a duration longer than 3 years. In such cases, the independent financial adviser will need to explain why a longer period for the agreement is required and to confirm that it is normal business practice for contracts of this type to be of such duration;

Note: *Examples of bases of calculation of the payments to be made include the sharing of costs, price per unit for on-going purchases, annual rental for a lease, and percentage of total construction cost for a management fee.*

- (2) in respect of each connected transaction, set a maximum aggregate annual value ("cap"), the basis of which must be disclosed. This annual cap must be expressed in terms of monetary value rather than a percentage of the issuer's annual revenue as derived from its latest published audited accounts or, where consolidated accounts have been prepared, its latest published audited consolidated accounts. The cap must be determined by reference to previous transactions and figures which are readily ascertainable from published information of the issuer. If there are no previous transactions, the cap must be made based on reasonable assumptions, details of which must be disclosed;

*Note: Reference to annual revenue and other bases may help to determine the monetary value of the cap.*

- (3) comply with the reporting and announcement requirements described in Main Board Listing Rules 14A.45 to 14A.47 / GEM Listing Rules 20.45 to 20.47;
- (4) comply with the independent shareholders' approval requirements described in Main Board Listing Rule 14A.48 / GEM Listing Rule 20.48 for transactions not falling under Main Board Listing Rule 14A.34 / GEM Listing Rule 20.34; and
- (5) comply with the annual review requirements described in Main Board Listing Rules 14A.37 to 14A.40 / GEM Listing Rules 20.37 to 20.40.

#### **Annual review of continuing connected transactions**

14A.37 / 20.37 When an issuer enters into a continuing connected transaction not falling under Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, each year the independent non-executive directors of the listed issuer must review the continuing connected transactions and confirm in the annual report and accounts that the transactions have been entered into:

- (1) in the ordinary and usual course of business of the listed issuer;
- (2) either on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the listed issuer than terms available to or from (as appropriate) independent third parties; and
- (3) in accordance with the relevant agreement governing them on terms that are fair and reasonable and in the interests of the shareholders of the listed issuer as a whole.

14A.38 / 20.38 When an issuer enters into a continuing connected transaction not falling under Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, each year the auditors must provide a letter to the listed issuer's board of directors (with a copy provided to the Exchange at least 10 business days prior to the bulk printing of the listed issuer's annual report), confirming that the continuing connected transactions:

- (1) have received the approval of the listed issuer's board of directors;
- (2) are in accordance with the pricing policies of the listed issuer if the transactions involve provision of goods or services by the listed issuer;
- (3) have been entered into in accordance with the relevant agreement governing the transactions; and
- (4) have not exceeded the cap disclosed in previous announcement(s).

14A.39 / 20.39 The listed issuer shall allow, and shall procure that the counterparty to the continuing connected transactions shall allow, the auditors sufficient access to their records for the purpose of reporting on the transactions as set out in this rule. The listed issuer's board of directors must state in the annual report whether its auditors have confirmed the matters stated in Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38.

Main Board Listing Rule 14A.40 A listed issuer shall promptly notify the Exchange and publish an announcement in accordance with Main Board Listing Rule 2.07C if it knows or has reason to believe that the independent non-executive directors and/or the auditors will not be able to confirm the matters set out in Main Board Listing Rules 14A.37 and/or 14A.38 respectively. The listed issuer may have to re-comply with Main Board Listing Rules 14A.35(3) and (4) and any other conditions the Exchange considers appropriate.

GEM Listing Rule 20.40 A listed issuer shall promptly notify the Exchange and publish an announcement if it knows or has reason to believe that the independent non-executive directors and/or the auditors will not be able to confirm the matters set out in GEM Listing Rules 20.37 and/or 20.38 respectively. The listed issuer may have to re-comply with GEM Listing Rules 20.35(3) and (4) and any other conditions the Exchange considers appropriate.

14A.41 / 20.41 Where a listed issuer has entered into an agreement involving continuing transactions and such transactions subsequently become continuing connected transactions for whatever reason (e.g. due to a party becoming a director of the listed issuer), the listed issuer must, immediately upon it becoming aware of this fact, comply with all applicable reporting, annual review and disclosure requirements of this Chapter in respect of all such continuing connected transactions. Upon any variation or renewal of the agreement, the listed issuer must comply in full with all applicable reporting, annual review, disclosure and independent shareholders' approval requirements of this Chapter in respect of all continuing connected transactions effected after such variation or renewal.

### **Reporting requirements**

14A.45 / 20.45 The following details of the connected transaction must be included in the listed issuer's next published annual report and accounts:

- (1) the transaction date;
- (2) the parties to the transaction and a description of their connected relationship;
- (3) a brief description of the transaction and its purpose;
- (4) the total consideration and terms (including, where relevant, interest rates, length of repayment and security); and
- (5) the nature and extent of the connected person's interest in the transaction.

14A.46 / 20.46 An issuer which has entered into a continuing connected transaction not falling under Main Board Listing Rule 14A.33 / GEM Listing Rule 20.33, must disclose the information set out in Main Board Listing Rule 14A.45 / GEM Listing Rule 20.45 in its subsequent published annual report and accounts for the financial years during which the issuer undertakes the transaction under the written agreement entered into pursuant to Main Board Listing Rule 14A.35(1) / GEM Listing Rule 20.35(1).

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

Main Board  
Listing Rule  
19A.04

The following terms, save where the context otherwise requires, have the following meanings:—

.....

**“PRC Governmental Body”**  
(中國政府機關)

for purposes of Main Board Listing Rules 19A.14 and 19A.19, includes (but not limited to)

- (a) PRC Central Government, including the State Council of the PRC (中國國務院), State Ministries and Commissions (國家部委), Bureaus and Administrations directly under the State Council (國務院直屬機構), State Council Offices and Institutions (國務院辦事機構及直屬國務院事業單位), Bureaus supervised by State Ministries and Commissions (國家部委代管局);
- (b) PRC Provincial-level Governments, including Provincial Governments (省政府), Municipalities directly under the Central Government (直轄市) and Autonomous Regions (自治區), together with their respective administrative arms, agencies and institutions.
- (c) PRC local governments immediately under the PRC Provincial-level Governments, including prefectures (區), municipalities (市) and counties (縣), together with their respective administrative arms, agencies and institutions.

*Note: For clarity, entities under the PRC Government that are engaging in commercial business or operating another commercial entity will be excluded from this definition.*

.....

**“PRC issuer”**  
[This term is also defined in GEM Listing Rule 1.01 with the same meaning]

an issuer which is duly incorporated in the PRC as a joint stock limited company (股份有限公司)

.....

GEM Listing Rule 25.04 In this Chapter

.....

(2) the term “PRC Governmental Body” means:—

- (a) PRC Central Government, including the State Council of the PRC (中國國務院), State Ministries and Commissions (國家部委), Bureaus and Administrations directly under the State Council (國務院直屬機構), State Council Offices and Institutions (國務院辦事機構及直屬國務院事業單位), Bureaus supervised by State Ministries and Commissions (國家部委代管局);
- (b) PRC Provincial-level Governments, including Provincial Governments (省政府), Municipalities directly under the Central Government (直轄市) and Autonomous Regions (自治區), together with their respective administrative arms, agencies and institutions; or
- (c) PRC Local Governments immediately under the PRC Provincial-level Governments, including prefectures (區), municipalities (市) and counties (縣), together with their respective administrative arms, agencies and institutions that is not engaging in commercial business or operating another commercial entity.

*Note: For clarity, entities under the PRC Government that are engaging in commercial business or operating another commercial entity will be excluded from this definition.*

## Appendix 2

### Example Independent Auditor's Letter on Continuing Connected Transactions

#### To the Board of Directors of XYZ Limited ("the Company")

In accordance with our agreed terms of engagement dated [date], we have carried out procedures on the attached list<sup>1</sup> of continuing connected transactions entered into by the Company and its subsidiaries (collectively referred to as "the Group") for the year ended [date] and which the directors have advised us are to be disclosed in the Company's annual report for the year ended [date] ("the disclosed continuing connected transactions").

#### Directors' responsibilities

The Directors of the Company are responsible for the completeness and accuracy of disclosures of continuing connected transactions and the Company's compliance with the [Main Board Listing Rules][GEM Listing Rules] issued by The Stock Exchange of Hong Kong Limited in respect of such transactions. This responsibility includes designing, implementing and maintaining internal controls relevant to the identification, recording, authorization and reporting of all continuing connected transactions.

#### Auditor's responsibilities

It is our responsibility to express a conclusion, based on our work, on the disclosed continuing connected transactions and to report our conclusion to you<sup>2</sup>.

#### Basis of conclusion

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants.

Our work consisted of making inquiries, primarily of persons responsible for financial and accounting matters, applying analytical and other review procedures and testing transactions on a sample basis where we considered appropriate. Our work was substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion on the disclosed continuing connected transactions.

Furthermore, due to the nature of connected persons and transactions, it was not practicable for us to determine whether the disclosed continuing connected transactions and the books and records of the Group include all continuing connected transactions. It was impracticable for us to quantify the potential impact of this on the disclosures of continuing connected transactions in the Company's annual report. Accordingly, our report relates solely to the continuing connected transactions that have been disclosed to us and in the books and records of the Group made available to us.

---

<sup>1</sup> This could either be a list of the continuing connected transactions disclosed in the listed issuer's annual report or an extract from the listed issuer's annual report that contains the relevant disclosures. Where the letter refers to the listed issuer's annual report, as the letter is to be issued at least 10 business days prior to bulk printing of the annual report, ordinarily the annual report will be in draft form when the auditor issues his letter.

<sup>2</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter 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".



## Conclusion

Based on the foregoing, in respect of the disclosed continuing connected transactions:

- a. nothing has come to our attention that causes us to believe that the disclosed continuing connected transactions have not been approved by the Company's board of directors.
- b. for transactions involving the provision of goods or services by the Group, nothing has come to our attention that causes us to believe that the transactions were not, in all material respects, in accordance with the pricing policies of the Company.
- c. nothing has come to our attention that causes us to believe that the transactions were not entered into, in all material respects, in accordance with the relevant agreements governing such transactions.
- d. with respect to the aggregate amount of [each of] the continuing connected transactions set out in the attached list of continuing connected transactions, nothing has come to our attention that causes us to believe that the disclosed continuing connected transactions have exceeded the maximum aggregate annual value disclosed in the previous announcement(s) dated [*relevant date(s)*] made by the Company in respect of [each of] the disclosed continuing connected transactions.

## Restrictions on the use of this letter

This letter is intended solely for the purpose of assisting you in respect of your obligations under the [Main Board Listing Rule 14A.38][GEM Listing Rule 20.38] with respect of continuing connected transactions. This letter is not intended to be, and should not be, used for any other purpose and we expressly disclaim any liability or duty to any other party in this respect including The Stock Exchange of Hong Kong Limited.

This letter should not be distributed to any other parties save that we agree that a copy of this letter may be provided by the Company to The Stock Exchange of Hong Kong Limited without further comment from us.

XYZ & Co.

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

[Address]

Date

## Appendix 3

### Example Engagement Letter

The following letter is to be used as a guide and will need to be adapted according to individual requirements and circumstances.

Auditors would seek their own advice as to the form of contract they wish to adopt and whether to include or attach other contractual terms of business. In addition, if auditors wish to include statements in the engagement letter limiting their liability and / or indemnifying them against third party claims in respect of the engagement, they would take legal advice concerning the wording of such statements and how they are communicated.

To the Board of Directors of [Name of the listed issuer] ("the Company")

We are providing this letter to confirm our understanding of the terms and objectives of our engagement to report on the continuing connected transactions of the Company and its subsidiaries ("the Group") to be disclosed in the Company's annual report ("Transactions"). The purpose of our engagement is to provide assistance to you in respect of the requirements set out in Chapter [14A][20] of the Rules Governing the Listing of Securities on [the Growth Enterprise Market of] The Stock Exchange of Hong Kong Limited ("the Listing Rules").

#### 1. Objective of our work

- 1.1 The objective of our work is to provide us with a basis for reporting whether anything has come to our attention that causes us to believe that:
- (a) the Transactions have not been approved by the Company's board of directors.
  - (b) for those Transactions that involve provision of goods or services by the Group, the Transactions were not, in all material respects, in accordance with the pricing policies of the Company.
  - (c) the Transactions were not entered into, in all material respects, in accordance with the relevant agreements governing such transactions.
  - (d) the Transactions have exceeded the maximum aggregate annual value disclosed in the relevant announcement(s) made by the Company in respect of each of the disclosed continuing connected transactions.

#### 2. Directors' responsibilities

- 2.1 The responsibility for ensuring the completeness and accuracy of disclosures of continuing connected transactions in the Company's annual report and for the Company's compliance with the Listing Rules with respect to continuing connected transactions and relevant laws and regulations rests solely with the Company and yourselves. This responsibility includes ensuring that the [Company][Group] has appropriate internal controls in place over the identification, recording, authorization and reporting of all connected persons and connected transactions; and has designed, implemented and maintained internal control to prevent and detect fraud and error. In addition, you will disclose to us the results of your assessment of the risk that the books of accounts, records and supporting documentation in respect of the [Company's][Group's] continuing connected transactions may be materially misstated as a result of fraud and your knowledge of fraud or suspected fraud and any allegations of fraud or suspected frauds affecting the [Company's][Group's] books of accounts, records and supporting documentation in respect of the [Company's][Group's] continuing connected transactions.

- 2.2 For the purposes of our work, you will make available to us, as and when required, all of the [Company's][Group's] books of account and all other relevant records and related information that we consider necessary. In addition, you will disclose to us the identity of the Company's connected persons and all the connected relationships and transactions of which you are aware.
- 2.3 We draw your attention to paragraph 37 of Chapter [14A][20] to the Listing Rules, which requires the Company's independent non-executive directors ("INEDs") to review and confirm in the annual report and accounts that the Transactions have been entered into:
- (a) in the ordinary and usual course of business of the Company;
  - (b) on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favorable to the Company than terms available to or from, as appropriate, independent third parties; and
  - (c) in accordance with the relevant agreement governing them on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

The INEDs also have the responsibility to determine the scope and extent of its review so as to discharge its duty under the Listing Rules. Our engagement should not be taken as a substitute or basis for the INEDs' review.

- 2.4 We may require receipt of written representations from the Company's board of directors, INEDs or other members of management in connection with certain matters relating to the Transactions before we issue our letter reporting on the matters set out in paragraph 1.1 above. In connection with representations and the supply of information to us generally, you are responsible for the accuracy and completeness of any information or documentation provided to us.
- 2.5 Once we have issued our letter, we have no further direct responsibility to update or actively seek information on events occurring subsequent to the date of our letter. You will inform us of any event occurring subsequent to the date of our letter that may impact on our letter, prior to the issuance of the Company's annual report.

### **3. Auditor's responsibilities**

- 3.1 Our responsibility is to express a conclusion, based on our work to be performed, on the disclosed continuing connected transactions and to report our conclusion to you.

### **4. Scope and limitations of our work**

- 4.1 Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). Our work will consist of making inquiries, primarily of persons responsible for financial and accounting matters, applying analytical and other review procedures and testing transactions on a sample basis where we consider appropriate. Our work is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently will not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we will not express an audit opinion on the Transactions.
- 4.2 In addition, due to the nature of connected transactions, we will not be in a position to confirm the completeness of the Transactions or whether the Transactions are in accordance with normal commercial terms or in compliance with relevant laws and regulations.

**5. Reporting, distribution and disclosure**

- 5.1 Our letter will be addressed to the board of directors and will be for your information only.
- 5.2 We will agree that a copy of the letter once issued may be provided to The Stock Exchange of Hong Kong Limited without further comment from us and that appropriate reference to our work in respect of the Transactions may be made in the Company's annual report. Such disclosure should appropriately reflect the nature of the work undertaken and the outcome of that work. We would be pleased to discuss those disclosures with you during the course of our engagement, although the responsibility for the appropriateness of disclosures in the Company's annual report rests solely with the Company.
- 5.3 Our letter shall not be copied, referred to or disclosed in whole or in part, other than as set out in this letter, and we expressly disclaim any liability to any party, including The Stock Exchange of Hong Kong Limited, other than the Company in respect of our work under this engagement.
- 5.4 Save as set out above, you shall not distribute our letter or make other references to us or our work or letter in this respect without our prior written consent, which shall not be unreasonably withheld.
- 5.5 We shall also report to you any material weaknesses in the Group's procedures that come to our attention in relation to this engagement and to which we think attention should be drawn. We shall exercise our professional judgment to determine the significance of any matter to be communicated and shall decide the appropriate means of communication. You should appreciate that our work should not be relied upon to identify all weaknesses, fraud or error that may exist.

**6. Other matters**

- 6.1 [We estimate that the fee for the work will be HK\$[*amount*], plus outlays which will be charged on an actual basis.][Our fee for the work has been incorporated in our audit fee which has been agreed with you separately.]
- 6.2 This letter shall be subject to and governed by Hong Kong law and all disputes arising from or under this engagement letter shall be subject to the exclusive jurisdiction of the Hong Kong courts.
- 6.3 This letter sets out the entire agreement and understanding between us and you in connection with the services to be delivered by us under this letter and supersedes all previous arrangements and understandings between us and you which shall cease to have any further force or effect.
- 6.4 This letter is effective in respect of reporting on continuing connected transactions in respect of the Company's annual report for the year [ending][ended] [*date*] and future years during our tenure as the Company's auditors or unless this letter is terminated by you or us, or amended or superseded by agreement in writing between you and us. Either party may terminate this engagement contract or suspend its operation by giving 30 days' prior notice in writing to the other at any time.

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

6.5 We should be grateful if you would confirm in writing your agreement to the terms of this letter by signing and returning the attached copy, or let us know if they are not in accordance with your understanding of our terms of appointment.

Yours faithfully

[Enclosures]

I have read and understood the terms and conditions of this letter and I agree to and accept them.

Signed

Date:

\_\_\_\_\_  
Duly authorized, for and on behalf of the Board of  
*[name of listed issuer]*

## Appendix 4

### Example Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

(letterhead of the listed issuer)

Date

To [Name of auditors]

Dear Sirs

This representation is provided in connection with the work you performed for the purpose of reporting on the continuing connected transactions of [Name of the listed issuer] ("the Company") and its subsidiaries ("the Group") for the year ended [date] ("the Continuing Connected Transactions") in accordance with the engagement letter dated [date of engagement letter].

We confirm, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves, the following representations given to you in respect of the above engagement:

1. We acknowledge that the work you performed was substantially less in scope than an audit and that, accordingly, you do not express an audit opinion on the Continuing Connected Transactions.
2. We acknowledge that we are responsible for ensuring, and confirm, that all continuing connected transactions entered into by the Group were in compliance with the applicable requirements as set out in Chapter [14A][20] of the Rules Governing the Listing of Securities on [the Growth Enterprise Market of] The Stock Exchange of Hong Kong Limited ("the Listing Rules").
3. We are responsible for, and confirm, the completeness and accuracy of the continuing connected transactions to be disclosed in the annual report and which are as set out in the attached Appendix.
4. We confirm that the Company has complied with the applicable reporting, approval and announcement requirements set out in the Listing Rules in respect of the continuing connected transactions.
5. We are responsible for ensuring, and confirm, that the [Company][Group] has appropriate internal controls over the identification, recording, authorization and reporting of all connected persons and connected transactions, including all continuing connected transactions.
6. We confirm that we are responsible for the design, implementation and maintenance of internal control to prevent and detect fraud and error and confirm the following:
  - we have disclosed our knowledge of fraud or suspected fraud affecting the [Company][Group] involving management, employees who have significant roles in internal control; or others where the fraud could have a material effect on the books of accounts, records and supporting documentation in respect of the [Company's][Group's] continuing connected transactions.

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

- we have disclosed our knowledge of any allegations of fraud or suspected frauds, affecting the [Company's][Group's] books of accounts, records and supporting documentation in respect of the Group's continuing connected transactions communicated by employees, former employees or others.
  - we believe that the risk that the books of accounts, records and supporting documentation in respect of the [Company's][Group's] continuing connected transactions may be materially misstated as a result of fraud is not significant, based on the results of our assessment<sup>3</sup>.
7. We confirm that we have made available to you all books of accounts, records and supporting documentation in respect of the Group's continuing connected transactions.
8. We confirm that we have disclosed to you the identity of the Company's connected persons and all the connected relationships and transactions of which we are aware.
9. We confirm that:
- the Continuing Connected Transactions have been approved by the Company's Board of Directors;
  - the prices charged for the Continuing Connected Transactions were in accordance with the Company's pricing policies;
  - there is a written agreement in place governing each of the Continuing Connected Transactions and the transactions have been entered into in accordance with such agreements. No side agreement has been entered into in respect of any transaction[, or if side agreements have been entered into, they have been made available to you]; [and]
  - the aggregate annual values of the Continuing Connected Transactions have not exceeded the maximum aggregate annual values of [*relevant amount(s)*] disclosed in previous announcement(s) dated [*relevant date(s)*] made by the Company in respect of [each of] the Continuing Connected Transaction(s)[.];[.];
10. We confirm that the Company's independent non-executive directors have reviewed the Continuing Connected Transactions and confirm that<sup>4</sup>:
- the terms of the relevant agreement governing each of the Continuing Connected Transactions are fair and reasonable and in the interests of the shareholders of the Company as a whole;
  - the Continuing Connected Transactions have been entered into in the ordinary and usual course of business of the Company; and
  - the Continuing Connected Transactions have been entered into on normal commercial terms or on terms no less favorable to the Company than terms available to or from independent third parties.

---

<sup>3</sup> In instances where management concluded that the risk of that the books of accounts, records and supporting documentation in respect of the [Company's][Group's] continuing connected transactions may be materially misstated as a result of fraud is not insignificant based on the results of their assessment, the wording may need to be adapted where appropriate.

<sup>4</sup> In instances where the INEDs' confirmation has not been issued before the representation letter on continuing connected transactions is issued, management should be requested to confirm that no issues have arisen to date (or alternatively that all such issues have been communicated to the auditor) and that management undertakes to inform the auditor of any issues arising between the date of the representation letter and the date of issuance by the INEDs of the INEDs' confirmation.

AUDITOR'S LETTER ON CONTINUING CONNECTED TRANSACTIONS  
UNDER THE HONG KONG LISTING RULES

11. We have considered the summary of misstatements attached to this letter and believe the effects of those misstatements aggregated by you during the engagement are immaterial, both individually and in the aggregate, and we consider that those misstatements do not constitute non-compliance with the applicable requirements of the Listing Rules regarding Continuing Connected Transactions.
12. [Set out further additional representations to address specific circumstances of the client.]

Yours faithfully

By Order of the Board

---

Name:  
Position:

---

Name:  
Position:



PN 900 (Clarified)  
Issued June 2010

---

Effective for audits of financial statements for periods  
beginning on or after 15 December 2009

*Practice Note 900 (Clarified)*

---

# **Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard**



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

## PRACTICE NOTE 900 (CLARIFIED)

# AUDIT OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH THE SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING STANDARD

(Issued June 2010)

## CONTENTS

---

	Paragraphs
Introduction .....	1 - 2
Qualifying Entities .....	3 - 4
Section 141D Exemptions and “True and Correct View” .....	5 - 6
Applicability of Hong Kong Standards on Auditing .....	7
Audit Procedures .....	8 - 10
Auditor’s Report .....	11 - 19
Appendix 1: Example Unqualified Auditor’s Report on Financial Statements Prepared in Accordance with the SME-FRS based on HKSA 700 “Forming an Opinion and Reporting on Financial Statements” – effective for audits of financial statements for periods beginning on or after 15 December 2009	
Appendix 2: Example Modified Auditors’ Reports on Financial Statements Prepared in Accordance with the SME-FRS based on HKSA 705 “Modifications to the Opinion in the Independent Auditor’s Report” – effective for audits of financial statements for periods beginning on or after 15 December 2009	
Appendix 3: Example Auditor’s Report that includes an Emphasis of Matter on Financial Statements Prepared in Accordance with the SME-FRS based on HKSA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report” – effective for audits of financial statements for periods beginning on or after 15 December 2009	

---

Practice Note (PN) 900 (Clarified) “Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard” should be read in the context of the “Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services” which sets out the application and authority of PNs.
---

## Introduction

1. In this Practice Note all the sections mentioned below are in respect of the Companies Ordinance unless otherwise stated.
2. This Practice Note gives guidance on the applicability of Hong Kong Standards on Auditing (HKSA) to the audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS). The Small and Medium-sized Financial Reporting Framework (SME-FRF) sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the SME-FRS.

## Qualifying Entities

3. In accordance with the SME-FRF:
  - a. a company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRF if it satisfies the criteria set out in section 141D of that Ordinance; and
  - b. an entity, other than a company incorporated under the Companies Ordinance, subject to any specific requirements imposed by the law of the entity's place of incorporation and subject to its constitution, qualifies for reporting under the SME-FRF when the entity does not have public accountability as defined in the SME-FRF, and:
    - i. all of its owners agree to prepare the financial statements in accordance with the SME-FRS; and
    - ii. the entity is considered to be an SME in terms of its size under the SME-FRF.
4. The definition of an SME is set out in paragraphs 16 to 26 of the SME-FRF.

## Section 141D Exemptions and “True and Correct View”

5. Section 141D exempts certain private companies from complying with the full disclosure requirements of the Companies Ordinance. In particular, companies which take advantage of these exemptions do not have to produce financial statements which show a true and fair view of the state of the company's affairs and of its profit or loss for the year. Instead the auditor is required to report on whether the company's balance sheet and accompanying notes show a true and correct view of the state of the company's affairs.
6. There is no statutory definition of a “true and correct view”. In accordance with paragraph 16 of the SME-FRF, compliance with the SME-FRF and SME-FRS is necessary in order for financial statements to give a “true and correct view” when a Hong Kong incorporated company prepares its financial statements in accordance with section 141D.

## Applicability of Hong Kong Standards on Auditing

7. HKSA apply whenever an audit is carried out, except where otherwise stated in the HKSA concerned. It follows that all HKSA are applicable to the audit of financial statements prepared in accordance with the SME-FRS.

## Audit Procedures

8. It is management's responsibility to ensure that the entity qualifies for reporting under the SME-FRF. An auditor would design and perform audit procedures to obtain sufficient appropriate audit evidence as to whether the entity qualifies for reporting under the SME-FRF.
9. Paragraph 18 of HKSA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing" states that the auditor shall comply with all HKSAs relevant to the audit. The same procedures would be adopted for all audits regardless of the financial reporting framework adopted.
10. For a company incorporated in Hong Kong applying section 141D, in addition to carrying out the audit procedures required by HKSAs, the auditor would ensure:
  - a. that the company is entitled to take advantage of the exemptions permitted under section 141D(3);
  - b. that the shareholders have entered into a new unanimous written agreement for the particular financial year under review; and
  - c. that the balance sheet and accompanying notes contain the information required under the Eleventh Schedule of the Companies Ordinance.

## Auditor's Report

11. An auditor is required to comply with the requirements of HKSA 700 "Forming an Opinion and Reporting on Financial Statements", HKSA 705 "Modifications to the Opinion in the Independent Auditor's Report" and HKSA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".
12. In an auditor's report on the financial statements prepared in accordance with the SME-FRS, the auditor expresses an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the SME-FRS.
13. In addition, for a company incorporated in Hong Kong applying section 141D, section 141D(1)(e) also requires the auditor's report to state:
  - a. whether or not the auditor has obtained all the information and explanations which they have required; and
  - b. whether, in their opinion, the balance sheet (together with the notes thereon) referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.
14. Appendix 1 contains an example of an unqualified auditor's report on the financial statements prepared in accordance with the SME-FRS based on HKSA 700.
15. Where the auditor is unable to give an unmodified opinion, the requirements relating to modified auditor's reports in HKSA 705 should be complied with.
16. Appendix 2 contains examples of modified auditors' reports on the financial statements prepared in accordance with the SME-FRS based on HKSA 705.
17. Where the auditor considers additional communication in the auditor's report is necessary, the requirements in HKSA 706 should be complied with.
18. Appendix 3 contains an example of an auditor's report that includes an Emphasis of Matter on the financial statements prepared in accordance with the SME-FRS based on HKSA 706.

19. It should be noted that, whilst the suggested auditor's report makes no reference to compliance with the disclosure provisions of the Companies Ordinance, the auditor still has an obligation under sections 161 and 161B to give details in their report of directors' remuneration and loans to officers to the extent that the information is not provided in the financial statements of a company applying section 141D.

## APPENDIX 1

**Example Unqualified Auditor’s Report on Financial Statements  
Prepared in Accordance with the SME-FRS based on  
HKSA 700 “Forming an Opinion and Reporting on Financial Statements”  
- effective for audits of financial statements for periods beginning on or after  
15 December 2009**

**Illustration:**

Circumstances include the following:

- **Audit of a complete set of financial statements.**
- **The financial statements are prepared for a general purpose by directors of the entity in accordance with the SME-FRS.**
- **The terms of the audit engagement reflect the description of directors’ responsibility for the financial statements in HKSA 210.<sup>1</sup>**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141D of the Hong Kong Companies Ordinance.**

**INDEPENDENT AUDITOR’S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>2</sup>

**[Report on the Financial Statements]<sup>3</sup>**

We have audited the financial statements of SME Limited (“the Company”) set out on pages ..... to ..... , which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>4</sup>

<sup>1</sup> HKSA 210, “Agreeing the Terms of Audit Engagements.”

<sup>2</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>3</sup> The sub-title “Report on the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on other matters under section 141D of the Hong Kong Companies Ordinance” is not applicable.

<sup>4</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Companies Ordinance.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>5</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" 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.

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 the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

### *Opinion*

In our opinion, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with the SME-FRS. [In addition, in our opinion the balance sheet together with the notes thereon is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>4</sup>

### **[Report on other matters under section 141D of the Hong Kong Companies Ordinance**

We report that we have obtained all the information and explanations which we have required.]<sup>4</sup>

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

---

<sup>5</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

## APPENDIX 2

**Example Modified Auditors' Reports on Financial Statements  
Prepared in Accordance with the SME-FRS based on HKSA 705  
"Modifications to the Opinion in the Independent Auditor's Report"  
- effective for audits of financial statements for periods beginning on or after  
15 December 2009**

- Illustration 1 – An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- Illustration 2 – An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence.
- Illustration 3 – An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the financial statements.
- Illustration 4 – An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.
- Illustration 5 – An auditor's report containing an adverse opinion due to a material misstatement of the financial statements.



**Illustration 1:**

**Circumstances include the following:**

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141D of the Hong Kong Companies Ordinance.**

**INDEPENDENT AUDITOR'S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>6</sup>

**[Report on the Financial Statements]<sup>7</sup>**

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to ....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>8</sup>

*Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>9</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" 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.

An audit involves performing procedures to obtain audit evidence about the amounts and

<sup>6</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>7</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under section 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>8</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>9</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

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 the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

*Basis for Qualified Opinion*

The Company's inventories are carried in the balance sheet at xxx. The directors have not stated the inventories at the lower of cost and net realizable value but have stated them solely at cost, which constitutes a departure from the SME-FRS. The Company's records indicate that had the directors stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

*Qualified Opinion*

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with the SME-FRS. [In addition, in our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the balance sheet together with the notes thereon is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>8</sup>

**[Report on other matters under section 141D of the Hong Kong Companies Ordinance**

We report that we have obtained all the information and explanations which we have required.]<sup>8</sup>

XYZ & Co.

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

[Auditor's Address]

Date of the auditor's report

**Illustration 2:**

**Circumstances include the following:**

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141(4), 141(6) and/ or 141D of the Hong Kong Companies Ordinance.**

## **INDEPENDENT AUDITOR'S REPORT**

### **TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>10</sup>

#### **[Report on the Financial Statements]<sup>11</sup>**

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>12</sup>

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>13</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" 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

<sup>10</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>11</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under section 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>12</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>13</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

from material misstatement.

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 the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

#### *Basis for Qualified Opinion*

The Company's investment in DEF Limited, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the balance sheet as at 31 December 20X1, and the Company's share of DEF's net income of xxx is included in the Company's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of the Company's investment in DEF as at 31 December 20X1 and the Company's share of DEF's net income for the year because we were denied access to the financial information, management, and the auditors of DEF. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

#### *Qualified Opinion*

In our opinion, except for the possible effects of matter described in the Basis for Qualified Opinion, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with the SME-FRS. [In addition, in our opinion, except for the possible effects of matter described in the Basis for Qualified Opinion, the balance sheet together with the notes thereon is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>12</sup>.

### **[Report on matters under sections 141(4), 141(6) and 141D of the Hong Kong Companies Ordinance**

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.]<sup>12</sup>

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

**Illustration 3:**

**Circumstances include the following:**

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the company's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141(4), 141(6) and/ or 141D of the Hong Kong Companies Ordinance.**

**INDEPENDENT AUDITOR'S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>14</sup>

**[Report on the Financial Statements]<sup>15</sup>**

We were engaged to audit the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>16</sup>

*Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit.<sup>17</sup> Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public

<sup>14</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>15</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under sections 141(4), 141(6) and 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>16</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>17</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

*Basis for Disclaimer of Opinion*

The Company's investment in its joint venture DEF (Country X) Limited is carried at xxx on the Company's balance sheet, which represents over 90% of the Company's net assets as at 31 December 20X1. We were not allowed access to the management and the auditors of DEF, including DEF's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Company's proportional share of DEF's assets that it controls jointly, its proportional share of DEF's liabilities for which it is jointly responsible, and its proportional share of DEF's income and expenses for the year.

*Disclaimer of Opinion*

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements. [In addition, we do not express an opinion on the balance sheet together with the notes thereon as to whether they are properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>16</sup>

**[Report on matters under sections 141(4), 141(6) and 141D of the Hong Kong Companies Ordinance**

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a joint venture:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.]<sup>16</sup>

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

**Illustration 4:**

**Circumstances include the following:**

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. That is, the auditor was unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141(4), 141(6) and/ or 141D of the Hong Kong Companies Ordinance.**

**INDEPENDENT AUDITOR'S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>18</sup>

**[Report on the Financial Statements]<sup>19</sup>**

We were engaged to audit the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>20</sup>

*Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit.<sup>21</sup> Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public

<sup>18</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>19</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under sections 141(4), 141(6) and 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>20</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>21</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

*Basis for Disclaimer of Opinion*

We were not appointed as auditors of the Company until after 31 December 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X0 and 20X1 which are stated in the balance sheet at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, the directors were still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the balance sheet at a total amount of xxx as at 31 December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement.

*Disclaimer of Opinion*

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements. [In addition, we do not express an opinion on the balance sheet together with the notes thereon as to whether they are properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>20</sup>

**[Report on matters under sections 141(4), 141(6) and 141D of the Hong Kong Companies Ordinance**

In respect alone of the inability to obtain sufficient appropriate audit evidence about the inventories and accounts receivable:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.]<sup>20</sup>

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report



**Illustration 5:**

**Circumstances include the following:**

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The financial statements are materially misstated due to the non-recognition of expected losses arise on certain long-term contracts as expenses. The material misstatement is deemed to be pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141D of the Hong Kong Companies Ordinance.**

**INDEPENDENT AUDITOR'S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**

(incorporated in [country or place] with limited liability)<sup>22</sup>

**[Report on the Financial Statements]<sup>23</sup>**

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>24</sup>

*Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>25</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" 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.

<sup>22</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>23</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under section 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>24</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>25</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report"

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 the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

*Basis for Adverse Opinion*

As explained in Note X, losses expected to arise on certain long-term contracts currently in progress have not been recognised as expenses, as the directors consider that such losses should be off-set against amounts recoverable on other long-term contracts. In our opinion, the expected losses on individual contracts should be recognised as expenses immediately as required by Section 8 of the SME-FRS. If losses had been so recognised the effect would have been to [reduce the profit/increase the loss] before taxation for the year and reduce the gross amounts due from customers at 31 December 20X1 by HK\$X.

*Adverse Opinion*

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements of the Company for the year ended 31 December 20X1 are not prepared, in accordance with the SME-FRS. [In addition, in our opinion the balance sheet together with the notes thereon is not properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>24</sup>

**[Report on other matters under section 141D of the Hong Kong Companies Ordinance**

We report that we have obtained all the information and explanations which we have required.]<sup>24</sup>

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

## APPENDIX 3

### Example Auditor's Report on Financial Statements Prepared in Accordance with the SME-FRS based on HKSA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

- effective for audits of financial statements for periods beginning on or after  
15 December 2009

Circumstances include the following:

- Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with the Small and Medium-sized Entity Financial Reporting Standard.
- The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.
- There is uncertainty relating to a pending exceptional litigation matter.
- A departure from the applicable financial reporting framework resulted in a qualified opinion.
- In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141D of the Hong Kong Companies Ordinance.

#### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF SME LIMITED

(incorporated in [country or place] with limited liability)<sup>26</sup>

#### [Report on the Financial Statements]<sup>27</sup>

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to ....., which comprise the balance sheet as at 31 December 20X1, and the income statement 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 in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, 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, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>28</sup>

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit.<sup>29</sup> We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN

<sup>26</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>27</sup> The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on other matters under section 141D of the Hong Kong Companies Ordinance" is not applicable.

<sup>28</sup> This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Hong Kong Companies Ordinance.

<sup>29</sup> Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

900 (Clarified) “Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard” 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.

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 the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

*Basis for Qualified Opinion*

The Company’s inventories are carried in the balance sheet at xxx. The directors have not stated the inventories at the lower of cost and net realizable value but have stated them solely at cost, which constitutes a departure from the SME-FRS. The Company’s records indicate that had the directors stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders’ equity would have been reduced by xxx, xxx and xxx, respectively.

*Qualified Opinion*

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with the SME-FRS. [In addition, in our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the balance sheet together with the notes thereon is properly drawn up so as to exhibit a true and correct view of the state of the Company’s affairs as at 31 December 20X1 according to the best of our information and explanations given to us, and as shown by the books of the Company.]<sup>28</sup>

*Emphasis of Matter*

We draw attention to Note X to the financial statements which describes the uncertainty<sup>30</sup> related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

**[Report on other matters under section 141D of the Hong Kong Companies Ordinance**

We report that we have obtained all the information and explanations which we have required.]<sup>28</sup>

XYZ & Co.

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

[Auditor’s address]

Date of the auditor’s report

---

<sup>30</sup> In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

---

Effective for audits of financial statements for periods  
beginning before 15 December 2009

*Practice Note 900 (Revised)*

---

# **Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard**

1. This PN900 (Revised) is applicable for audits of financial statements for periods beginning before 15 December 2009.
2. For audits of financial statements for periods beginning on or after 15 December 2009, PN900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" is applicable.



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

## PRACTICE NOTE 900 (REVISED)

### AUDIT OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH THE SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING STANDARD

(Issued December 2006; revised June 2010; Effective for audits of financial statements for periods beginning before 15 December 2009)

## CONTENTS

---

	Paragraphs
Introduction .....	1 - 2
Qualifying Entities .....	3 - 4
Section 141D Exemptions and “True and Correct View” .....	5 - 6
Applicability of Hong Kong Standards on Auditing .....	7
Audit Procedures .....	8 - 10
Auditor’s Report .....	11 - 16
Appendix: Example Unqualified Auditor’s Report on Financial Statements Prepared in Accordance with the SME-FRS based on HKSA 700 “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” – effective for audits of financial statements for periods beginning before 15 December 2009	

---

Practice Note (PN) 900 (Revised) “Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard” should be read in the context of the “Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services” which sets out the application and authority of PNs.

## APPENDIX

**Example Unqualified Auditor's Report on Financial Statements  
Prepared in Accordance with the SME-FRS based on HKSA 700 "The  
Independent Auditor's Report on a Complete Set of  
General Purpose Financial Statements"  
- effective for audits of financial statements for periods beginning before  
15 December 2009**

**INDEPENDENT AUDITOR'S REPORT  
TO THE SHAREHOLDERS OF SME LIMITED**  
(incorporated in [country or place] with limited liability)

**Report on the Financial Statements**

We have audited the financial statements of SME Limited set out on pages ..... to ..... , which comprise the balance sheet as at 31 December 200X, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Directors' responsibility for the financial statements*

The directors are responsible for the preparation and presentation of these financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

[In addition, section 141D of the Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]<sup>1</sup>

*Auditor's responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit<sup>2</sup>. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Revised) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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