



August 2005

To: **Members of the Hong Kong Institute of CPAs**
All other interested parties

Exposure Draft
Proposed Practice Note 900
“Audit of Financial Statements Prepared
in Accordance with the Small and Medium-sized Entity
Financial Reporting Standard”

Comments to be received by 15 October 2005

Issued by the Council,
Hong Kong Institute of Certified Public Accountants

The Hong Kong Institute of Certified Public Accountants' Council (Council) has issued for consultation an Exposure Draft of proposed Practice Note 900.

Council invites comments on the Exposure Draft from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the Exposure Draft. Comments should be supported by specific reasoning and should preferably be submitted in written form.

The Exposure Draft is available at:

www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/ed-pn900.pdf.

Comments are requested to be received by **15 October 2005** and may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

August 2005
Exposure Draft

Response Due Date
15 October 2005

Practice Note 900

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

Information for Commentators

1. In August 2005, the Institute issued the Small and Medium-sized Entity Financial Reporting Framework (SME-FRF) and Financial Reporting Standard (SME-FRS) which are available on the Institute's website at:
www.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumell/sme-frf&sme-frs.pdf. This proposed Practice Note seeks to give guidance on the applicability of Hong Kong Standards on Auditing to the audit of financial statements prepared in accordance with the SME-FRS.
2. The SME-FRF and SME-FRS are applicable to companies that satisfy the criteria set out in section 141D of the Companies Ordinance (section 141D) and other entities that meet the qualifying criteria set out in the SME-FRF.
3. For companies applying section 141D, section 141D requires the auditors' report to state whether, in the auditors' opinion, the balance sheet exhibits a true and correct view of the state of the company's affairs.
4. With the introduction of the SME-FRF, compliance with the SME-FRF and SME-FRS is necessary in order for section 141D financial statements to give a "true and correct view". Since the income statement forms part of the financial statements under the SME-FRS, the example auditors' report in this proposed PN also covers the income statement.
5. This proposed PN will apply to the audit of financial statements prepared in accordance with the SME-FRS, including companies applying section 141D, that cover a period beginning on or after 1 January 2005. The existing PN 600.2 continues to apply to the audit of companies applying section 141D that cover a period beginning before 1 January 2005 (except where a company early adopts the SME-FRS, in which case this proposed PN will apply).

This Exposure Draft may be filed in the "Exposure Drafts, Invitations to Comment" section of Volume III of the HKICPA Members' Handbook.

A copy of the Exposure Draft can also be found on the HKICPA's website at:
www.hkicpa.org.hk/professionalttechnical/assurance/exposedraft/ed-pn900.pdf.

EXPOSURE DRAFT

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

(Effective upon issue)

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Practice Note (PN) 900 “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.

PRACTICE NOTE 900

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

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 (HKSAAs) 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 auditors are 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. HKSAAs apply whenever an audit is carried out, except where otherwise stated in the HKSAAs concerned. It follows that all HKSAAs 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. Auditors 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 5 of HKSA 200 "Objectives and General Principles Governing an Audit of Financial Statements" states that the auditor should conduct an audit in accordance with HKSA's. 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 HKSA's, the auditors 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.

Auditors' Report

11. Auditors are required to comply with the requirements of SAS 600 "Auditors' Reports on Financial Statements".
12. In an auditors' report on the financial statements prepared in accordance with the SME-FRS, the auditors express an opinion as to whether the financial statements have been properly 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 auditors' report to state:
 - a. whether or not the auditors have 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. The Appendix contains an example of an unqualified auditors' report on the financial statements prepared in accordance with the SME-FRS.
15. Where the auditors are unable to give an affirmative opinion, the requirements relating to qualified auditors' reports in SAS 600 should be complied with. Consequently the auditors refer to all material matters about which they have reservations in a separate paragraph or paragraphs in the auditors' report.
16. It should be noted that, whilst the suggested auditors' report makes no reference to compliance with the disclosure provisions of the Companies Ordinance, the auditors still have 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

Example Unqualified Auditors' Report on Financial Statements Prepared in Accordance with the SME-FRS

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

We have audited the financial statements on pages to..... which have been prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS).

Respective responsibilities of directors and auditors

The company's directors are responsible for the preparation of the financial statements. In preparing those statements in accordance with the SME-FRS, it is fundamental that appropriate accounting policies are selected and applied consistently.

[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.]¹

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you².

Basis of opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 "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. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion the financial statements have been properly prepared, in all material respects, in accordance with the SME-FRS. [In addition, we report that we have obtained all the information and explanations which we have required and 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 [balance sheet date] according to the best of our information and explanations given to us, and as shown by the books of the company.]¹

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
Hong Kong
Date

Footnote 1 – This additional wording is required for companies incorporated in Hong Kong applying section 141D of the Companies Ordinance.

Footnote 2 – Practising members may consider it appropriate to include a limitation of liability 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".