

PN 900 (Revised)  
Issued September 2014; revised August 2016,  
June 2019, December 2021, May 2022, July 2023

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Effective for a Qualifying Entity's financial statements  
which cover a period ending on or after 15 December 2016

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

Practice Note 900 (Revised) has been updated to reflect the amendments of the Companies (Amendment) (No. 2) Ordinance 2018. Please refer to paragraph 3 of this Practice Note for the effective date of the amendments. Earlier application of the amendments is not permitted.



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

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## PRACTICE NOTE 900 (REVISED)

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

(Issued September 2014; revised August 2016, June 2019, December 2021, May 2022, July 2023)

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Practice Note (PN) 900 (Revised), <i>Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard</i> should be read in the context of the <i>Preface to the Hong Kong Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements</i> which sets out the application and authority of PNs.
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**PRACTICE NOTE  
900 (REVISED)  
AUDIT OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE  
WITH THE SMALL AND MEDIUM-SIZED ENTITY  
FINANCIAL REPORTING STANDARD**

*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. In this Practice Note all the sections mentioned below are in respect of the new Companies Ordinance (Cap. 622) (“new CO”) which became effective on 3 March 2014, unless otherwise stated. The new requirements apply to the first financial year<sup>1</sup> of companies that begins on or after the commencement date of the new CO and all subsequent financial years (i.e. typically the first set of financial statements covered would be for a financial period ending on or after 2 March 2015. Generally, for companies incorporated prior to 3 March 2014 with a calendar year end, the first applicable financial period is for the year ending 31 December 2015).
2. The new CO contains an optional reporting exemption for certain private companies and companies limited by guarantee which satisfy the conditions set out in section 359 of the new CO. On 7 December 2018, the Government of the Hong Kong Special Administrative Region published the Companies (Amendment) (No. 2) Ordinance 2018 (“the 2018 Amendment Ordinance”) to amend some of the provisions in the new CO so as to improve the clarity and operation of the new CO and further facilitate business in Hong Kong.<sup>2</sup> These amendments include amendments relating to the eligibility criteria set out in section 359 of the new CO. The Small and Medium-sized Entity Financial Reporting Framework (“revised SME-FRF”) and Financial Reporting Standard (“revised SME-FRS”) (“revised SME-FRF & SME-FRS”) which are effective for annual periods beginning on or after 3 March 2014 are the accounting standards issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) that are to be followed in accordance with section 380(4) by those Hong Kong incorporated companies which are entitled to, and decide to,<sup>3</sup> take advantage of this reporting exemption in the new CO, as amended by the 2018 Amendment Ordinance.

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<sup>1</sup> Section 367(1) of the new CO states that a company’s first financial year after the coming into operation of this section begins on the first day of its first accounting reference period and ends on the last day of that period.

<sup>2</sup> Source: press release issued by the Government of the Hong Kong Special Administrative Region on 7 December 2018.

<sup>3</sup> The reporting exemption is optional for those companies which are eligible. If a non-dormant private company or company limited by guarantee is not eligible, or decides not to take advantage of the reporting exemption, then it should prepare financial statements which comply with all the relevant requirements of the new CO, including subsections (1), (2), 3(b), (4), (5) and (6) of section 380. Subsections (1), (2), (5) and (6) of section 380 relate to the requirement for the financial statements to give a true and fair view of the financial position of the company (or the company and all its subsidiary undertakings, as the case may be) as at the end of the financial year and the financial performance of the company (or the company and all its subsidiary undertakings, as the case may be) for the financial year. Subsection (4) of section 380 requires compliance with the accounting standards applicable to the financial statements. In the case of a company not taking advantage of the reporting exemption, this would be Hong Kong Financial Reporting Standards (HKFRSs) or Hong Kong Financial Reporting Standard for Private Entities (HKFRSs for Private Entities) as issued by the HKICPA.

3. 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 revised SME-FRS. It takes into account all relevant subsequent amendments to the new CO, up to and including the 2018 Amendment Ordinance which was enacted on 28 November 2018 and commenced operation on 1 February 2019. Key revisions to the Practice Note as a result of the 2018 Amendment Ordinance are double underlined for ease of reference. As a consequence of the 2018 Amendment Ordinance, paragraphs 4 and 12 of this Practice Note have been amended.

## Qualifying Entities

4. In accordance with the revised SME-FRF:
- a. a company incorporated under the new CO or predecessor CO (Cap. 32) qualifies for reporting under the revised SME-FRF<sup>4</sup> if it satisfies the criteria set out in section 359 of the new CO and the sections and Schedules to which that section refers. Specifically:
    - i. Section 359(1)(b) brings forward the qualifying criteria that were previously found in section 141D of the predecessor CO, relating to private companies which do not have subsidiaries and are not a subsidiary of another company. These companies (unless they fall within the types of companies listed in section 359(4)) are eligible for the reporting exemption provided that each year they obtain 100% approval in writing from their members.
    - ii. The remainder of section 359 introduces 4 categories of entities (or groups) that fall within the reporting exemption if they meet certain criteria relating to the type of entity (or group), the size of the entity (or group) and in certain cases the need for member approval. Further details on these criteria are set out in paragraphs 24 to 43 of the revised SME-FRF.
    - iii. Qualifying groups may consist of Hong Kong and non-Hong Kong incorporated body corporates.<sup>5</sup>
  - b. an entity which is not a company incorporated under either the new CO or the predecessor CO, 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 revised SME-FRF when the entity meets the same requirements that a Hong Kong incorporated entity is required to meet under section 359 of the new CO.
5. The types of companies that can qualify for the reporting exemption under the new CO are set out in paragraphs 22 to 43 of the revised SME-FRF.

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<sup>4</sup> As stated in footnote 3, taking advantage of the reporting exemption is optional even if the company qualifies. If a company which is eligible does not take advantage of the reporting exemption then its financial statements should be prepared in accordance with HKFRSs or HKFRSs for Private Entities as issued by the HKICPA instead of the revised SME-FRS. Further details are stated in footnote 3.

<sup>5</sup> The double underlined criteria in paragraphs 4(a)(ii) and (iii), as amended by the 2018 Amendment Ordinance, are effective for a Qualifying Entity's financial statements which cover a financial year beginning on or after 1 February 2019. Earlier application is not permitted.

## Reporting Exemption

6. As introduced above in paragraph 4, the new CO permits private companies and companies limited by guarantee to take advantage of a “reporting exemption” if they meet certain qualifying criteria set out in section 359. The reporting exemption takes the form of exemption from certain of the requirements for the contents of the directors’ report and financial statements that would apply if the entities did not qualify for the exemption. The exemptions are explicitly stated in the new CO: if a section, Schedule or Regulation of the new CO does not explicitly refer to the reporting exemption, then companies are required to follow that requirement irrespective of their size and status.
7. Of these exemptions, the most significant one for the purposes of the revised SME-FRF & SME-FRS is the exemption from the requirement for the financial statements to give a true and fair view as set out in section 380(7) of the new CO. Instead of preparing financial statements under the fair presentation framework, financial statements prepared by entities taking advantage of the reporting exemption are required to be properly prepared in accordance with the revised SME-FRF & SME-FRS as these are the applicable accounting standards for such companies for the purposes of complying with section 380(4)(b). With reference to paragraph 13(a) of HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, revised SME-FRF is considered to be a compliance framework. The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not (i) acknowledge explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or (ii) acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements.
8. Regardless of whether a company falls or does not fall within the reporting exemption, the auditor of the company is required under section 406 of the new CO to opine in the auditor’s report on whether the financial statements have been properly prepared in compliance with the new CO. In accordance with the Hong Kong Framework for Assurance Engagements, this is a form of “reasonable assurance” as the auditor is required to express a positive form of conclusion.

## Applicability of Hong Kong Standards on Auditing

9. Paragraph 18 of HKSA 200 states that the auditor shall comply with all HKSAs relevant to the audit. This requirement applies to all audits regardless of the financial reporting framework adopted. It follows that all HKSAs are applicable to the audit of financial statements prepared in accordance with the revised SME-FRS.

## Audit Procedures

### General

10. It is management’s responsibility to ensure that the entity qualifies for reporting under the revised SME-FRF & SME-FRS and to ensure that the financial statements are prepared in accordance with the requirements of the SME-FRF & SME-FRS and the new CO.
11. For a company which applies section 359 of the new CO, the auditor should perform audit procedures to obtain sufficient appropriate audit evidence as to whether:
  - a. the company is entitled to take advantage of the reporting exemptions permitted under section 359 of the new CO, taking account of the following:
    - i. only certain types of companies can qualify for the reporting exemption;

- ii. there are size tests set out in Schedule 3 of the new CO for the purposes of the reporting exemption; and
- iii. there are requirements for member approval for certain types of companies which take advantage of the reporting exemption.

Auditors should refer to section 359 of the new CO and Schedule 3 to the new CO for the details of requirements.

- b. the financial statements comply with revised SME-FRS, Part 1 of Schedule 4 of the new CO and any other requirements of the new CO in relation to the financial statements of a company that falls within reporting exemption.

### Consolidated financial statements

12. In accordance with section 379 of the new CO, an entity which is a parent at the end of the financial year is required to present consolidated financial statements in accordance with the SME-FRS except when:

- a. it is a wholly-owned subsidiary of another entity at the end of the financial year; or
- b. it is a partially-owned subsidiary of another entity at the end of the financial year and it meets either of the following conditions:
  - i. at least 6 months before the end of the financial year, the directors notify the members in writing of the directors' intention not to prepare consolidated financial statements for the financial year, and the notification does not relate to any other financial year; and

as at a date falling 3 months before the end of the financial year, no member has responded to the notification by giving the directors a written request for the preparation of consolidated financial statements for the financial year; or

- ii. all members agree in writing before the end of the financial year that consolidated financial statements will not be prepared for the financial year and the agreement does not relate to any other financial year<sup>6</sup>.

If a parent is exempt from preparing consolidated financial statements and does not prepare such financial statements, it should prepare company-level financial statements. Company-level financial statements are those in which investments in subsidiaries, associates and joint ventures are accounted for using the cost model set out in Section 6 of the revised SME-FRS & SME-FRS.

13. Consistent with section 381, paragraph 19.2 of the revised SME-FRS states that if consolidated financial statements are presented, they should include all subsidiaries of the parent, except that one or more subsidiaries may be excluded from consolidation when:

- a. their exclusion measured on an aggregate basis is not material to the group as a whole; or
- b. their inclusion would involve expense and delay out of proportion to the value to members of the company.

14. Paragraph 19.3 of the revised SME-FRS states that a parent may not exclude a subsidiary from consolidation on the grounds of expense and delay out of proportion to the value to

<sup>6</sup> The double underlined criteria in paragraph 12(b), as amended by the 2018 Amendment Ordinance, came into immediate effect on 1 February 2019. Earlier application is not permitted.

members of the company unless the members of the company have been informed in writing about, and do not object to, this exclusion. In order to satisfy this condition:

- a. the notification to the members of the company must:
    - i. state which financial year that the notification relates to (and the notification must not relate to more than one financial year);
    - ii. specify the subsidiary or subsidiaries proposed to be excluded; and
    - iii. state the directors' reasons for believing that the inclusion of the subsidiary or subsidiaries in the consolidated financial statements may involve expense and delay out of proportion to the value to the shareholders;
  - b. in the case of an entity which needs to obtain shareholder approval in accordance with section 359 of the new CO in order to qualify for the reporting exemption, the notification to the members of the company proposing to exclude one or more subsidiaries from consolidation must be included as part of the notice to obtain the necessary shareholder approvals required to qualify for the reporting exemption and must be subject to the same approval and objection processes as apply to that approval;
  - c. in all other cases the notification must be sent to the members before the date of approval of the financial statements and must allow the members of the company a period of no less than one month to raise objections, unless all the members of the company confirm that such a period is not necessary; and
  - d. within the time frame allowed in accordance with subparagraph (b) or (c) of this paragraph no member has indicated to the company that they disagree with the directors' assertion that the inclusion of the subsidiary or subsidiaries would involve expense and delay out of proportion to the value to members of the company.
15. If an entity excludes a subsidiary or subsidiaries from consolidation on the grounds of expense and delay out of proportion to the value to members of company, having satisfied the conditions set out in paragraph 19.3 of the SME-FRS, then paragraph 19.16(g) of the SME-FRS requires the entity to disclose in its consolidated financial statements particulars of each subsidiary that has been excluded from consolidation in accordance with paragraph 19.2(b) of the revised SME-FRS including:
- a. the name of the subsidiary;
  - b. the principal place of operation and place of incorporation and an indication of the nature of business, the proportion of ownership interest and, if different, proportion of voting power held;
  - c. any amounts recognised in the entity's income statement in respect of:
    - i. dividends received or receivable from the excluded subsidiary;
    - ii. impairment losses relating to the investment in the excluded subsidiary; and
    - iii. other transactions with the excluded subsidiary;



- d. amounts recognised in the entity's statement of financial position in respect of:
    - i. investment in the excluded subsidiary; and
    - ii. any balances due to or from the excluded subsidiary;
  - e. whether the excluded subsidiary prepares audited financial statements;
  - f. summarised financial information in respect of the excluded subsidiary, including the excluded subsidiary's:
    - i. revenue;
    - ii. profit before tax;
    - iii. income tax expense;
    - iv. profit after tax;
    - v. total assets; and
    - vi. total liabilities.
  - g. the basis of preparation of the summarised financial information disclosed in respect of the excluded subsidiary, including:
    - i. the period covered by the information;
    - ii. the accounting framework adopted in its preparation; and
    - iii. whether the information has been extracted from audited financial statements and if not, why not.
16. In relation to the disclosures stated in paragraph 15 above, the auditor of the company would normally evaluate whether the disclosures are in compliance with the requirements set out in the revised SME-FRS. This evaluation is a matter of professional judgment and takes into account matters such as the facts and circumstances of the entity and its subsidiaries based on the auditor's knowledge of the entity and its subsidiaries and the audit evidence obtained during the audit relating to the accuracy and completeness of the disclosures. However, as these subsidiaries are excluded from the scope of the consolidated financial statements, the auditor is not required to comply with the additional requirements of HKSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* so far as these subsidiaries are concerned.
17. An example engagement letter in connection with the audit of financial statements prepared in accordance with the revised SME-FRS and an example representation letter are set out in Appendices 4 and 5, respectively.

## Auditor's Report

18. Regardless whether a company falls or does not fall within the reporting exemption, the auditor of the company is required under section 406 to opine in the auditor's report on whether the financial statements have been properly prepared in compliance with the new CO. This is a form of "reasonable assurance" as the auditor is required to express a positive form of conclusion. Therefore, HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* applies to the audit of the financial statements prepared in accordance with the revised SME-FRS. An auditor should also refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* and HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* if necessary.
19. As explained in paragraph 7 of this Practice Note, the revised SME-FRS is a compliance framework i.e. a financial reporting framework that is not a fair presentation framework. In accordance with paragraph A13 of HKSA 200, where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Therefore, in an auditor's report on the financial statements prepared in accordance with the revised SME-FRS, the auditor expresses an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the revised SME-FRS.
20. In addition, regardless whether a company falls or does not fall within the reporting exemption, the auditor of the company is required under sections 406 and 407 to opine in the auditor's report (i) if, in the opinion of the auditor, the information in a directors' report is not consistent with the financial statements; and (ii) on certain other matters, as and when necessary. Guidance on these reporting requirements is provided in Practice Note 600.1 (Revised), *Reports by the Auditor under the Companies Ordinance (Cap. 622)*.
21. Appendix 1 contains examples of unmodified auditor's reports on the financial statements and consolidated financial statements prepared in accordance with the revised SME-FRS based on HKSA 700 (Revised).
22. Where the auditor is unable to give an unmodified opinion, the requirements relating to modified auditor's reports in HKSA 705 (Revised) should be complied with. Appendix 2 contains examples of modified SME auditor's reports on the financial statements prepared in accordance with the revised SME-FRS based on HKSA 705 (Revised).
23. Where the auditor considers additional communication in the auditor's report is necessary, the requirements in HKSA 706 (Revised) should be complied with. 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 revised SME-FRS based on HKSA 706 (Revised).

## APPENDIX 1

### **Example Unmodified Auditor's Reports on Financial Statements Prepared in Accordance with the revised SME-FRS based on HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements***

Illustration 1 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard.

Illustration 2 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong submitting Consolidated Financial Statements and where the Consolidated Financial Statements are Prepared in Accordance with the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard.

**Illustration 1 - Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.<sup>7</sup>
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised)<sup>8</sup>.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Companies Ordinance.

## **INDEPENDENT AUDITOR'S REPORT**

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>9</sup>

### **Report on the Audit of the Financial Statements<sup>10</sup>**

#### **Opinion**

We have audited the financial statements of SME Limited ("the Company") set out on pages ..... to ..... , which comprise the statement of financial position as at 31 December 20X1, and the income

<sup>7</sup> HKSA 210, *Agreeing the Terms of Audit Engagements*.

<sup>8</sup> HKSA 570 (Revised), *Going Concern*

<sup>9</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>10</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

statement [and cash flow statement]<sup>11</sup> for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the financial statements of the Company are prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Opinion**

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).]

### **Responsibilities of Directors and Those Charged with Governance for the Financial Statements<sup>12</sup>**

The directors are responsible for the preparation of the financial statements in accordance with the SME-FRS issued by the HKICPA and the Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company’s financial reporting process.

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion.<sup>13</sup> Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSA will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material

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<sup>11</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

<sup>12</sup> Throughout the illustrative auditor’s reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<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”.

if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

## Report on Other Legal and Regulatory Requirements

*[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.]<sup>14</sup>*

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[Auditor Address]

[Date]

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<sup>14</sup> For further guidance on non-compliance with the Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

**Illustration 2 - Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong submitting Consolidated Financial Statements and where the Consolidated Financial Statements are Prepared in Accordance with the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the group audit engagement reflect the description of directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Companies Ordinance.

## INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>15</sup>

### Report on the Audit of the Consolidated Financial Statements<sup>16</sup>

#### Opinion

We have audited the consolidated financial statements of SME Limited ("the Company") and its subsidiaries ("the Group") set out on pages ..... to ..... , which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated income statement [and

<sup>15</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>16</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.



consolidated cash flow statement]<sup>17</sup> for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the consolidated financial statements of the Group are prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Opinion**

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).]

### **Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements<sup>18</sup>**

The directors are responsible for the preparation of the consolidated financial statements in accordance with the SME-FRS issued by the HKICPA and the Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group’s financial reporting process.

### **Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion.<sup>19</sup> Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are

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<sup>17</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

<sup>18</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

<sup>19</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”.

considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSA's expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSA's, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

## Report on Other Legal and Regulatory Requirements

*[The form and content of this section of the auditor’s report would vary depending on the nature of the auditor’s other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as “other reporting responsibilities”) shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSA’s as part of the Report on the Audit of the Consolidated Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSA’s may be combined (i.e., included in the Report on the Audit of the Consolidated Financial Statements section under the appropriate subheadings) provided that the wording in the auditor’s report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSA’s where such a difference exists.]*<sup>20</sup>

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[Auditor Address]

[Date]

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<sup>20</sup> For further guidance on non-compliance with the Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*, Appendix, Illustrations 3, 4 and 5.

## APPENDIX 2

### **Example Modified Auditor's Reports on Financial Statements Prepared in Accordance with the revised SME-FRS based on HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report***

- 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 regarding cash sales.
- 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 consolidated 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 consolidated financial statements.

### Illustration 1 - Qualified Opinion due to a Material Misstatement of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- 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 (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the qualified opinion on the financial statements also affects the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Companies Ordinance.

## **INDEPENDENT AUDITOR'S REPORT**

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>21</sup>

### **Report on the Audit of the Financial Statements<sup>22</sup>**

#### **Qualified Opinion**

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to ....., which comprise the statement of financial position as at 31 December 20X1, and the income statement [and cash flow statement]<sup>23</sup> for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements of the Company are prepared, in all material respects, in

<sup>21</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>22</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

<sup>23</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Qualified Opinion**

The Company’s inventories are carried in the statement of financial position 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.

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 6 in Appendix 2 of HKSA 720 (Revised). The last paragraph of the other information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

### **Responsibilities of Directors and Those Charged with Governance for the Financial Statements<sup>24</sup>**

*[See illustration 1 in Appendix 1 to this practice note.]*

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

*[See illustration 1 in Appendix 1 to this practice note.]*

### **Report on Other Legal and Regulatory Requirements**

*[See illustration 1 in Appendix 1 to this practice note.]*

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

*[Auditor Address]*

*[Date]*

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<sup>24</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

**Illustration 2 - Qualified Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence Regarding Cash Sales**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- 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 cash sales. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the qualified opinion on the financial statements also affects the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Companies Ordinance.
- The information in the directors' report is not consistent with the financial statements.

## INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>25</sup>

### Report on the Audit of the Financial Statements

#### Qualified Opinion

We have audited the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the statement of financial position as at 31 December 20X1, and the income statement [and cash flow statement]<sup>26</sup> for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

<sup>25</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>26</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

In our opinion, except for the possible effects of matter described in the *Basis for Qualified Opinion* section of our report, the financial statements of the Company are prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Qualified Opinion**

\$X of the Company’s recorded turnover comprises cash sales, over which there was no system of internal control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to satisfy ourselves that the recorded turnover was free from material misstatements.

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### **Other Information [or another title if appropriate, such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustrations 6 and 8 in Appendix 2 of HKSA 720 (Revised). The last paragraph of the other information section would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

### **Responsibilities of Directors and Those Charged with Governance for the Financial Statements<sup>27</sup>**

*[See illustration 1 in Appendix 1 to this practice note.]*

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

*[See illustration 1 in Appendix 1 to this practice note.]*

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<sup>27</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.



## Report on [Directors' Report under section 406(2) and]<sup>28</sup> Other Matters under sections 407(2)<sup>29</sup> and 407(3)<sup>29</sup> of the Companies Ordinance<sup>30</sup>

### [Directors' and Auditor's Respective Responsibility for the Directors' Report<sup>28</sup>

In addition to the respective responsibilities of the directors and auditor stated in above section "Report on the Audit of the Financial Statements", the directors are also responsible for the preparation of the directors' report as set out on pages ... to ... in compliance with the Companies Ordinance.

It is our responsibility under section 406(2) of the Companies Ordinance to state in our auditor's report if we are of the opinion that the information in the directors' report is not consistent with the financial statements. However, we have not audited or reviewed the directors' report and accordingly do not express an audit opinion or a review conclusion or any assurance conclusion on the directors' report as a whole.]

### Matters on Which We are Required to Report by Exception

In accordance with the Companies Ordinance, we have the following matters to report. In our opinion:

- [the information given in [insert relevant paragraph/ section] in the directors' report for the year ended 31 December 20X1 is not consistent with the financial statements for the year ended 31 December 20X1. [State the details of the inconsistencies<sup>28</sup>.]]
- in respect alone of the inability to obtain sufficient appropriate audit evidence regarding cash sales as described in the *Basis for Qualified Opinion* section of our report above:
  - we were unable to determine whether adequate accounting records had been kept; and
  - we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[Auditor Address]

[Date]

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<sup>28</sup> Section 406(2) of the Companies Ordinance ("CO") requires the auditor to opine on the directors' report:

- (2) If a company's auditor is of the opinion that the information in a directors' report for a financial year is not consistent with the financial statements for the financial year, the auditor-
  - (a) must state that opinion in the auditor's report; and
  - (b) may bring that opinion to the members' attention at a general meeting.

<sup>29</sup> Section 407 of the CO requires the auditor to opine on other matters:

- (1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  - (a) whether adequate accounting records have been kept by the company; and
  - (b) whether the financial statements are in agreement with the accounting records.
- (2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  - (a) adequate accounting records have not been kept by the company; or
  - (b) the financial statements are not in agreement with the accounting records in any material respect.
- (3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
- (4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

<sup>30</sup> For the requirements under the Companies Ordinance, reference may be made to Practice Note 600.1 (Revised), *Reports by auditors under the Companies Ordinance (Cap. 622)*.

Illustration 3: Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about a Single Element of the Consolidated Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated 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 entity'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 consolidated financial statements (i.e., a disclaimer of opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- The auditor has obtained all of the other information prior to the date of the auditor's report.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the consolidated financial statements, the auditor has no other reporting responsibilities required under local law except for the Companies Ordinance.
- The information in the directors' report is not consistent with the consolidated financial statements.

## INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>31</sup>

### Report on the Audit of the Consolidated Financial Statements

#### Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of SME Limited and its subsidiaries ("the Group") set out on pages ..... to....., which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated income statement [and consolidated cash flow statement]<sup>32</sup> for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

<sup>31</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>32</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

We do not express an opinion on the consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements. In all other respects, in our opinion the consolidated financial statements have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Disclaimer of Opinion**

The Group's investment in its joint venture DEF Limited is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at 31 December 20X1. We were not allowed access to the management and the auditors of DEF, including DEF's auditor's audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's share of the profits/losses and the net assets/liabilities of DEF.

### **Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements<sup>33</sup>**

[See illustration 2 in Appendix 1 to this practice note.]

### **Auditor's Responsibilities for the Audit of the Consolidated Financial Statements**

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with Hong Kong Standards on Auditing ("HKSA") and with reference to Practice Note 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 ("HKICPA") and to issue an auditor's report.<sup>34</sup> However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code.

### **Report on [Directors' Report under section 406(2) and]<sup>35</sup> Other Matters under sections 407(2)<sup>36</sup> and 407(3)<sup>36</sup> of the Companies Ordinance<sup>37</sup>**

<sup>33</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

<sup>34</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".

<sup>35</sup> Section 406(2) of the Companies Ordinance ("CO") requires the auditor to opine on the directors' report:

- (2) If a company's auditor is of the opinion that the information in a directors' report for a financial year is not consistent with the financial statements for the financial year, the auditor-
  - (a) must state that opinion in the auditor's report; and
  - (b) may bring that opinion to the members' attention at a general meeting.

<sup>36</sup> Section 407 of the CO requires the auditor to opine on other matters:

- (1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  - (a) whether adequate accounting records have been kept by the company; and
  - (b) whether the financial statements are in agreement with the accounting records.
- (2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  - (a) adequate accounting records have not been kept by the company; or
  - (b) the financial statements are not in agreement with the accounting records in any material respect.
- (3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
- (4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

<sup>37</sup> For the requirements under the Companies Ordinance, reference may be made to Practice Note 600.1 (Revised), *Reports by auditors under the Companies Ordinance (Cap. 622)*.

[Directors' and Auditor's Respective Responsibility for the Directors' Report<sup>35</sup>

In addition to the respective responsibilities of the directors and auditor stated in above section "Report on the Audit of the Consolidated Financial Statements", the directors are also responsible for the preparation of the directors' report as set out on pages ... to ... in compliance with the Companies Ordinance.

It is our responsibility under section 406(2) of the Companies Ordinance to state in our auditor's report if we are of the opinion that the information in the directors' report is not consistent with the consolidated financial statements. However, we have not audited or reviewed the directors' report and accordingly do not express an audit opinion or a review conclusion or any assurance conclusion on the directors' report as a whole.]

**Matters on Which We are Required to Report by Exception**

In accordance with the Companies Ordinance, we have the following matters to report. In our opinion:

- [the information given in [*insert relevant paragraph/ section*] in the directors' report for the year ended 31 December 20X1 is not consistent with the financial statements for the year ended 31 December 20X1. [*State the details of the inconsistencies*<sup>35</sup>.]]
- in respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a joint venture as described in the *Basis for Disclaimer of Opinion* section of our report above:
  - we were unable to determine whether adequate accounting records had been kept; and
  - we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

Illustration 4: Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- 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 also 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.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- The auditor has obtained all of the other information prior to the date of the auditor's report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Companies Ordinance.
- The information in the directors' report is not consistent with the financial statements.

## INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>38</sup>

### Report on the Audit of the Financial Statements

#### Disclaimer of Opinion

We were engaged to audit the financial statements of SME Limited (the "Company") set out on pages ..... to....., which comprise the statement of financial position as at 31 December 20X1, and the income statement [and cash flow statement]<sup>39</sup> for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the financial statements of the Company. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements. In all other respects, in our opinion the financial statements

<sup>38</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>39</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

have been properly prepared in compliance with the Companies Ordinance.

### **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 statement of financial position 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 statement of financial position 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.

### **Responsibilities of Directors and Those Charged with Governance for the Financial Statements<sup>40</sup>**

[See illustration 1 in Appendix 1 to this practice note.]

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our responsibility is to conduct an audit of the Company's financial statements in accordance with Hong Kong Standards on Auditing ("HKSA") and with reference to Practice Note 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 and to issue an auditor's report.<sup>41</sup> However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code.

### **Report on [Directors' Report under section 406(2) and]<sup>42</sup> Other Matters under sections 407(2)<sup>43</sup> and 407(3)<sup>43</sup> of the Companies Ordinance<sup>44</sup>**

<sup>40</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

<sup>41</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".

<sup>42</sup> Section 406(2) of the Companies Ordinance ("CO") requires the auditor to opine on the directors' report:

- (2) If a company's auditor is of the opinion that the information in a directors' report for a financial year is not consistent with the financial statements for the financial year, the auditor-
  - (a) must state that opinion in the auditor's report; and
  - (b) may bring that opinion to the members' attention at a general meeting.

<sup>43</sup> Section 407 of the CO requires the auditor to opine on other matters:

- (1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  - (a) whether adequate accounting records have been kept by the company; and
  - (b) whether the financial statements are in agreement with the accounting records.
- (2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  - (a) adequate accounting records have not been kept by the company; or
  - (b) the financial statements are not in agreement with the accounting records in any material respect.
- (3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
- (4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

[Directors' and Auditor's Respective Responsibility for the Directors' Report<sup>42</sup>

In addition to the respective responsibilities of the directors and auditor stated in above section "Report on the Audit of the Financial Statements", the directors are also responsible for the preparation of the directors' report as set out on pages ... to ... in compliance with the Companies Ordinance.

It is our responsibility under section 406(2) of the Companies Ordinance to state in our auditor's report if we are of the opinion that the information in the directors' report is not consistent with the financial statements. However, we have not audited or reviewed the directors' report and accordingly do not express an audit opinion or a review conclusion or any assurance conclusion on the directors' report as a whole.]

**Matters on Which We are Required to Report by Exception**

In accordance with the Companies Ordinance, we have the following matters to report. In our opinion:

- [the information given in [*insert relevant paragraph/ section*] in the directors' report for the year ended 31 December 20X1 is not consistent with the financial statements for the year ended 31 December 20X1. [*State the details of the inconsistencies*<sup>42</sup>.]]
- in respect alone of the inability to obtain sufficient appropriate audit evidence about the inventories and accounts receivable as described in the *Basis for Disclaimer of Opinion* section of our report above:
  - we were unable to determine whether adequate accounting records had been kept; and
  - we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

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<sup>44</sup> For the requirements under the Companies Ordinance, reference may be made to Practice Note 600.1 (Revised), *Reports by auditors under the Companies Ordinance (Cap. 622)*.

Illustration 5: Adverse Opinion due to a Material Misstatement of the Consolidated Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of directors' responsibility for the consolidated financial statements in HKSA 210.
- The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the adverse opinion on the consolidated financial statements also affects the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Companies Ordinance. Assume compliance with the Companies Ordinance on non-consolidation of a subsidiary.

## INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>45</sup>

### Report on the Audit of the Consolidated Financial Statements<sup>46</sup>

#### Adverse Opinion

We have audited the consolidated financial statements of SME Limited and its subsidiaries (the "Group") set out on pages ..... to....., which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated income statement [and consolidated cash

<sup>45</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>46</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.



flow statement]<sup>47</sup> for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the consolidated financial statements of the Group are not prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”). In all other respects, in our opinion the consolidated financial statements have been properly prepared in compliance with the Companies Ordinance.<sup>48</sup>

### **Basis for Adverse Opinion**

As explained in Note X, the Group has not consolidated subsidiary DEF Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary’s material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under SME-FRS, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had DEF Company been consolidated, many elements in the consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

### **Other Information [or another title if appropriate, such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 7 in Appendix 2 of HKSA 720 (Revised). The last paragraph of the other information section in illustration 7 would be customized to describe the specific matter giving rise to the adverse opinion that also affects the other information.]*

### **Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements<sup>49</sup>**

*[See illustration 2 in Appendix 1 to this practice note.]*

### **Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

*[See illustration 2 in Appendix 1 to this practice note.]*

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<sup>47</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

<sup>48</sup> Assume the consolidated financial statements have been properly prepared in accordance with the Companies Ordinance in all other aspects.

<sup>49</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

## **Report on Other Legal and Regulatory Requirements**

*[See illustration 2 in Appendix 1 to this practice note.]*

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

*[Auditor Address]*

*[Date]*

## APPENDIX 3

### **Example Auditor’s Report on Financial Statements Prepared in Accordance with the revised SME-FRS based on HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report***

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the revised Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the revised SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of directors’ responsibility for the financial statements in HKSA 210.
- A departure from the applicable financial reporting framework resulted in a qualified opinion.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants’ *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with HKSA 570 (Revised).
- There is uncertainty relating to a pending exceptional litigation matter.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor’s report and the matter giving rise to the qualified opinion on the financial statements also affects the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Companies Ordinance.

## **INDEPENDENT AUDITOR’S REPORT**

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)<sup>50</sup>

### **Report on the Audit of the Financial Statements<sup>51</sup>**

#### **Qualified Opinion**

We have audited the financial statements of SME Limited (the “Company”) set out on pages ..... to ....., which comprise the statement of financial position as at 31 December 20X1, and the income

<sup>50</sup> In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

<sup>51</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

statement [and cash flow statement]<sup>52</sup> for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements of the Company are prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard (“SME-FRS”) issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) and have been properly prepared in compliance with the Companies Ordinance.

### **Basis for Qualified Opinion**

The Company’s inventories are carried in the statement of financial position 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.

We conducted our audit in accordance with Hong Kong Standards on Auditing (“HKSA”) and with reference to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA’s *Code of Ethics for Professional Accountants* (“the Code”), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### **Emphasis of Matter – Uncertainty Related to a Lawsuit**

We draw attention to Note X to the financial statements which describes the uncertainty<sup>53</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.

### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 6 in Appendix 2 of HKSA 720 (Revised). The last paragraph of the other information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

### **Responsibilities of Directors and Those Charged with Governance for the Financial Statements<sup>54</sup>**

*[See illustration 1 in Appendix 1 to this practice note.]*

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

*[See illustration 1 in Appendix 1 to this practice note.]*

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<sup>52</sup> An entity which prepares and presents its financial statements in accordance with the revised SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

<sup>53</sup> In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

<sup>54</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

## Report on Other Legal and Regulatory Requirements

[See illustration 1 in Appendix 1 to this practice note.]

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[Auditor Address]

[Date]

## APPENDIX 4

### Example of an Audit Engagement Letter

*The following is an example of an audit engagement letter for an audit of general purpose financial statements of a company which is incorporated in Hong Kong under the Companies Ordinance and which has decided to take advantage of the reporting exemption in the Companies Ordinance. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in HKSA 210 Agreeing the Terms of Audit Engagements. It will need to be varied according to individual requirements and circumstances, for example to the special reporting requirements of regulated entities. It may be appropriate to seek legal advice that any proposed letter is suitable.*

To the directors of [SME Limited]:

#### Objective of services

- 1.1 You have requested that we audit the (consolidated)\* financial statements of SME Limited (“the Company”) (and its subsidiaries)\*. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.
- 1.2 The objectives of our audit are to obtain reasonable assurance about whether the (consolidated)\* financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Hong Kong Standards on Auditing (“HKSA”) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these (consolidated)\* financial statements.

#### Responsibilities of directors

- 2.1 Our audit will be conducted on the basis that you acknowledge and understand that you have responsibility:
  - a. To ensure that the company satisfies the relevant requirements under section 359 of the Companies Ordinance (“CO”) such that the company is eligible to take advantage of the reporting exemption;
  - b. To prepare (consolidated)\* financial statements of the Company (and its subsidiaries)\* for the financial year in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) and the CO;
  - c. (To ensure the subsidiary, if any, of the Company keeps accounting records that are sufficient for the Company to prepare (consolidated)\* financial statements that comply with b. above.)\*
  - d. To take all reasonable steps to ensure the Company keeps sufficient accounting records which show and explain the transactions of the Company (and its subsidiaries)\*, and disclose with reasonable accuracy, at any time, the financial position and financial performance of the Company (and its subsidiaries)\*;
  - e. To ensure that the (consolidated)\* financial statements comply with section 383 (Notes to Financial Statements to Contain Information on Directors’ Emoluments etc) of the CO which must contain in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G);

- f. For such internal control as you determine is necessary to enable the preparation of (consolidated)\* financial statements that are free from material misstatement, whether due to fraud or error;
  - g. To provide us with:
    - (i) Access to all information of which you are aware that is relevant to the preparation of the (consolidated)\* financial statements such as Company's accounting records and all other relevant records and documentation, including minutes of all management and shareholders' meetings and other matters;
    - (ii) Additional information that we may request from you for the purpose of the audit; and
    - (iii) Unrestricted access to persons related to the Company (and its subsidiaries)\* from whom we determine it necessary to obtain audit evidence;
  - h. To provide us with (i) any proposed written resolution and (ii) any other document relating to the resolution that is required to be sent to a member of the Company, on or before the circulation of written resolution to a member of the Company; and
  - i. To notify us any passed written resolution within 15 days after resolution is passed.
- 2.2 You are also responsible for the preparation and approval of the directors' report in accordance with the CO.

### **Responsibilities of the auditor**

- 3.1 We have a statutory responsibility to prepare a report to the members to state whether in our opinion the (consolidated)\* financial statements of the Company (and its subsidiaries)\* for the financial year are prepared, in all material respects, in accordance with the SME-FRS and whether they have been properly prepared in compliance with the CO. We shall also state our opinion in the auditor's report if we are of the opinion that:
- a. adequate accounting records have not been kept by the Company (and its subsidiaries)\*; or
  - b. the (consolidated)\* financial statements are not in agreement with the accounting records in any material respect; and

We shall also state the fact in the auditor's report if we have failed to obtain all the information and explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

In addition, where the (consolidated)\* financial statements do not contain information relating to directors' remuneration or loans to officers under section 383(1) of the CO, the CO requires us to include in our report, as far as we are reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the (consolidated)\* financial statements.

- 3.2 We have a professional responsibility to report if the (consolidated)\* financial statements do not comply in any material respect with SME-FRS, unless in our opinion the non-compliance is justified in the circumstances. In determining whether or not the departure is justified, we consider:
- a. whether the departure is required in order for the (consolidated)\* financial statements to properly present the financial position and financial performance of the Company (and its subsidiaries)\*; and
  - b. whether adequate disclosure has been made concerning the departure.

- 3.3 We are required to read the information in the directors' report for the financial year to identify and report inconsistencies with the (consolidated)\* financial statements. As required by the CO, if we are of the opinion that the information in the directors' report for a financial year is not consistent with the (consolidated)\* financial statements for the financial year, we shall state that opinion in our auditor's report; and we may bring that opinion to the members' attention at a general meeting. However, we are not required to audit or review the directors' report and accordingly we will not express an opinion or review conclusion or any assurance on it.

### Scope of audit

- 4.1 Our audit will be conducted in accordance with HKSAs and with reference to Practice Note 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. As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:
- a. Identify and assess the risks of material misstatement of the (consolidated)\* financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
  - b. Obtain an understanding of internal control relevant to the audit 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. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the (consolidated)\* financial statements that we have identified during the audit. Any such report may not be provided to third parties without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the Company in mind and that we accept no duty or responsibility to any other party as concerns the reports.
  - c. Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by you.
  - d. Conclude on the appropriateness of your use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- 4.2 Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs.
- (4.3 In connection with the audit of the consolidated financial statements, we draw your attention to section 412 of the CO which gives the rights to the auditor of the holding company to require a person that is a related entity of the company to provide any information or explanation that the auditor reasonably requires for the performance of the duties as auditor of the holding company. As defined in section 412 of the CO, a related entity includes an auditor of a subsidiary undertaking.



- 4.4 In order to express an opinion on the consolidated financial statements which consolidate the financial information of subsidiaries of which we are not the auditor, it will be necessary for us to communicate directly with the other auditor(s) concerned to satisfy ourselves that:
- a. so far as is practicable, there is uniformity within the Company and its subsidiaries in the application of accounting policies;
  - b. the consolidated financial statements contain the information required by the CO, applicable accounting standards and any other legislation or non-statutory requirements affecting the presentation of financial statements; and
  - c. all material aspects of the consolidated financial statements have been subjected to an audit, the nature and extent of which is adequate and reasonable, in our view, for the purpose of forming an opinion on the consolidated financial statements.)\*
- 4.5 As part of our audit procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the audit in connection with the audit. In connection with representations and the supply of information to us generally, we draw your attention to section 412 of the CO which sets out the rights of the auditor in relation to obtaining information from a person that is a related entity as defined in this section of the CO. You are also referred to section 413 of the CO which sets out the offences relating to section 412 of the CO.
- 4.6 In order to assist us with the audit of your (consolidated)\* financial statements, we shall request sight of all documents or statements, including the directors' report, which are due to be issued with the (consolidated)\* financial statements. We are also entitled to attend all general meetings of the Company and to receive notice of all such meetings.
- 4.7 The responsibility for safeguarding the assets of the Company (and its subsidiaries)\* and for the prevention and detection of fraud, error and non-compliance with law or regulations rests with you. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the (consolidated)\* financial statements or books of account (including those resulting from fraud, error or non-compliance with law or regulations), but our audit should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist.
- 4.8 (Where appropriate - Note) We shall not be treated as having notice, for the purposes of our audit responsibilities, of information provided to members of our firm other than those engaged on the audit (for example information provided in connection with accounting, taxation and other services).
- 4.9 Once we have issued our report we have no further direct responsibility in relation to the (consolidated)\* financial statements for that period. However, you agree that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the (consolidated)\* financial statements.

### **Reporting**

- 5.1 [*Insert appropriate reference to the expected form and content of the auditor's report including, if applicable, the reporting on other information in accordance with HKSA 720 (Revised).*]
- 5.2 The form and content of our report may need to be amended in the light of our audit findings.

### **(Other services**

6. You have requested that we provide other services in respect of ..... The terms under which we provide these other services are dealt with in a separate letter.)\*

### **Fees**

7. Our fees are computed on the basis of the time spent on your affairs by our partners and our staff and on the levels of skill and responsibility involved plus out-of-pocket expenses. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the audit and will be due on presentation.

**Agreement of terms**

- 8.1 Once it has been agreed, this letter will remain effective, from one audit appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the (consolidated)\* financial statements including our respective responsibilities.
- (8.2 Since the terms of our engagement as auditors of the subsidiaries listed in the attached appendix are the same, we will not send separate letters to the board of directors of each subsidiary. We would therefore be grateful if you would forward copies of this letter to the boards of directors of each such subsidiary and confirm that these boards have also agreed and confirmed their acceptance of this letter.)\*

Yours faithfully,

ABC & Co.

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

Date

We agree to the terms of this letter.

(Signed)

.....

Director, for and on behalf of the board of

Date

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\* Delete where not applicable.

**Note**

*When accounting, taxation or other services are undertaken on behalf of an audit client, information may be provided to members of the audit firm other than those engaged on the audit. In such cases, it may be appropriate for the audit engagement letter to include this or a similar paragraph to indicate that the auditor is not to be treated as having notice, for the purposes of the auditor's responsibilities, of such information, to make it clear that a company would not be absolved from informing the auditor directly of a material matter.*

## APPENDIX 5

### Example of a Representation Letter

The following illustrative letter includes written representations that are required by HKSA 580, *Written Representations* and other HKSAs. It is assumed in this illustration that a company is incorporated in Hong Kong under the Companies Ordinance and which has decided to take advantage of the reporting exemption in the Companies Ordinance; the applicable financial reporting framework is the Small and Medium-sized Entity Financial Reporting Standard; the requirement of HKSA 570 (Revised), *Going Concern* to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of SME Limited for the year ended 31 December 20XX<sup>55</sup> for the purpose of expressing an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Small and Medium-sized Entity Financial Reporting Standard.

We confirm that (*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

#### *Financial Statements*

- We consider the company falls within the reporting exemption set out in section 359.
- We acknowledge that section 379 of the Companies Ordinance requires us to prepare financial statements that comply with sections 380 and 383.
- We are responsible for taking all reasonable steps to ensure the company keeps proper accounting records which are sufficient to show and explain the company's transactions, disclose with reasonable accuracy at any time the company's financial position and financial performance and enable us to ensure that the financial statements comply with the Companies Ordinance.
- The financial statements comply with section 383 (Notes to Financial Statements to Contain Information on Directors' Emoluments etc) of the Companies Ordinance which must contain in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G).
- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard; in particular the financial statements are prepared, in all material respects, in accordance therewith.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (HKSA 540 (Revised))
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of the Small and Medium-sized Entity Financial Reporting Standard. (HKSA 550)
- All events subsequent to the date of the financial statements and for which the Small and Medium-sized Entity Financial Reporting Standard require adjustment or disclosure have been adjusted or disclosed. (HKSA 560)

<sup>55</sup> Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (HKSA 450)
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of HKSA 580).]

#### *Directors' Report*

- We are responsible for the preparation of the director's report that:
  - complies with sections 390 (Contents of Directors' Report: General) and 543(2) (Disclosure of Management Contract) of the Companies Ordinance;
  - contains the information prescribed by the regulations made under section 452(3) (Financial Secretary May Make Other Regulations) of the Companies Ordinance; and
  - complies with other requirements prescribed by the regulations made under section 452(3) of the Companies Ordinance.

#### *Information Provided*

- We have provided you with:<sup>56</sup>
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
  - Additional information that you have requested from us for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (HKSA 240)
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (HKSA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (HKSA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (HKSA 250 (Revised))
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (HKSA 550)
- [Any other matters that the auditor may consider necessary (see paragraph A11 of HKSA 580).]

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Management

Management

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<sup>56</sup> If the auditor has included other matters relating to management's responsibilities in the audit engagement letter in accordance with HKSA 210, *Agreeing the Terms of Audit Engagements*, consideration may be given to including these matters in the written representations from management or those charged with governance.