

PN 900 (Clarified)
Issued June 2010

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

Practice Note 900 (Clarified)

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



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

PRACTICE NOTE 900 (CLARIFIED)

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

(Issued June 2010)

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

Introduction

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

Qualifying Entities

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

Section 141D Exemptions and “True and Correct View”

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

Applicability of Hong Kong Standards on Auditing

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

Audit Procedures

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

Auditor's Report

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

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

APPENDIX 1

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

Illustration:

Circumstances include the following:

- **Audit of a complete set of financial statements.**
- **The financial statements are prepared for a general purpose by directors of the entity in accordance with the SME-FRS.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.¹**
- **In addition to the audit of the financial statements, the auditor may have other reporting responsibilities required under local law e.g. section 141D of the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF SME LIMITED

(incorporated in [country or place] with limited liability)²

[Report on the Financial Statements]³

We have audited the financial statements of SME Limited ("the Company") set out on pages to , which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]⁴

¹ HKSA 210, "Agreeing the Terms of Audit Engagements."

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

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

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit⁵. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

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

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

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

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

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

APPENDIX 2

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

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

Illustration 1:

Circumstances include the following:

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

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

(incorporated in [country or place] with limited liability)⁶

[Report on the Financial Statements]⁷

We have audited the financial statements of SME Limited (the "Company") set out on pages to, which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]⁸

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit⁹. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

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

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

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

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

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

Basis for Qualified Opinion

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

Qualified Opinion

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

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

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

XYZ & Co.

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

[Auditor's Address]

Date of the auditor's report

Illustration 2:

Circumstances include the following:

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

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF SME LIMITED

(incorporated in [country or place] with limited liability)¹⁰

[Report on the Financial Statements]¹¹

We have audited the financial statements of SME Limited (the "Company") set out on pages to....., which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]¹²

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit¹³. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free

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

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

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

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

from material misstatement.

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

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

Basis for Qualified Opinion

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

Qualified Opinion

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

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

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

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

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

Illustration 3:

Circumstances include the following:

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

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

(incorporated in [country or place] with limited liability)¹⁴

[Report on the Financial Statements]¹⁵

We were engaged to audit the financial statements of SME Limited (the "Company") set out on pages to....., which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]¹⁶

Auditor's Responsibility

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

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

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

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

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

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

Basis for Disclaimer of Opinion

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

Disclaimer of Opinion

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

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

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

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

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

Illustration 4:

Circumstances include the following:

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

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

(incorporated in [country or place] with limited liability)¹⁸

[Report on the Financial Statements]¹⁹

We were engaged to audit the financial statements of SME Limited (the "Company") set out on pages to....., which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]²⁰

Auditor's Responsibility

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

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

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

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

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

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

Basis for Disclaimer of Opinion

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

Disclaimer of Opinion

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

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

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

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

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

Illustration 5:

Circumstances include the following:

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

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

(incorporated in [country or place] with limited liability)²²

[Report on the Financial Statements]²³

We have audited the financial statements of SME Limited (the "Company") set out on pages to....., which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]²⁴

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit²⁵. We conducted our audit in accordance with Hong Kong Standards on Auditing and with reference to PN 900 (Clarified) "Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard" issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance²⁵ about whether the financial statements are free from material misstatement.

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

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

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

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

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

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

Basis for Adverse Opinion

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

Adverse Opinion

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

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

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

XYZ & Co.

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

[Auditor's address]

Date of the auditor's report

APPENDIX 3

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

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

Circumstances include the following:

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

INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF SME LIMITED

(incorporated in [country or place] with limited liability)²⁶

[Report on the Financial Statements]²⁷

We have audited the financial statements of SME Limited (the "Company") set out on pages to, which comprise the balance sheet as at 31 December 20X1, and the income statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS) issued by the Hong Kong Institute of Certified Public Accountants, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

[In addition, section 141D of the Hong Kong Companies Ordinance requires that the balance sheet together with the notes thereon should be prepared in accordance with the requirements of the Eleventh Schedule to that Ordinance.]²⁸

Auditor's Responsibility

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

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

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

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

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

900 (Clarified) “Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard” issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Basis for Qualified Opinion

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

Qualified Opinion

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

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty³⁰ related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

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

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

XYZ & Co.

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

[Auditor’s address]

Date of the auditor’s report

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