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

Hong Kong Standard on Auditing 210

Agreeing the Terms of Audit Engagements



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HONG KONG STANDARD ON AUDITING 210
AGREEING THE TERMS OF AUDIT ENGAGEMENTS

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

CONTENTS

	Paragraph
Introduction	
Scope of this HKSA	1
Effective Date	2
Objective	3
Definitions	4-5
Requirements	
Preconditions for an Audit	6-8
Agreement on Audit Engagement Terms	9-12
Recurring Audits	13
Acceptance of a Change in the Terms of the Audit Engagement	14-17
Additional Considerations in Engagement Acceptance	18-21
Conformity and Compliance with International Standards on Auditing	22-23
Application and Other Explanatory Material	
Scope of this HKSA	A1
Preconditions for an Audit	A2-A21
Agreement on Audit Engagement Terms	A22-A29
Recurring Audits	A30
Acceptance of a Change in the Terms of the Audit Engagement	A31-A35
Additional Considerations in Engagement Acceptance	A36-A39
Appendix 1: Example of an Audit Engagement Letter	
Appendix 2: Determining the Acceptability of General Purpose Frameworks	

Hong Kong Standard on Auditing (HKSA) 210, *Agreeing the Terms of Audit Engagements*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. HKSA 220¹ deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

2. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
 - (a) Establishing whether the preconditions for an audit are present; and
 - (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the HKSAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise² on which an audit is conducted.
5. For the purposes of this HKSA, references to "management" should be read hereafter as "management and, where appropriate, those charged with governance."

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:
 - (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A10)
 - (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para. A11-A14, A21)

¹ HKSA 220, *Quality Control for an Audit of Financial Statements*

² HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 13

- (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15)
- (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A16-A19)
- (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on Scope Prior to Audit Engagement Acceptance

- 7. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

- 8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:
 - (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or
 - (b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

- 9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A22)
- 10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter^{2a} or other suitable form of written agreement and shall include: (Ref: Para. A23-A27)
 - (a) The objective and scope of the audit of the financial statements;
 - (b) The responsibilities of the auditor;

^{2a} Under the Corporate Practices (Registration) Rules of the HKICPA, the engagement letter for a corporate practice shall identify the director appointed by the corporate practice to be responsible for the performance of the audit engagement contemplated by the audit report.

- (c) The responsibilities of management^{2b};
 - (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
 - (e) Reference to the expected form and content of any reports to be issued by the auditor; and (Ref: Para. A24)
 - (f) A statement that there may be circumstances in which a report may differ from its expected form and content.
11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A23, A28-A29)
 12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A28)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A30)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A31-A33)
15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A34-A35)
16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
 - (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
 - (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators^{2c}.

^{2b} Under the Companies Ordinance, directors are responsible for the preparation of financial statements showing a true and fair view.

^{2c} Auditor of a company incorporated under the Companies Ordinance who resigns or is removed from the office as auditor or where the auditor's term of office expires and not reappointed is required to comply with the requirements of sections 424 or 425 of the Companies Ordinance regarding the statement to be made by the auditor in relation to the resignation, removal or retirement.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation

18. If financial reporting standards established by an authorized or recognized standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:
- (a) The additional requirements can be met through additional disclosures in the financial statements; or
 - (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with HKSA 705 (Revised).³ (Ref: Para. A36)

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A37)
- (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and
 - (b) It is recognized in the terms of the audit engagement that:
 - (i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with HKSA 706 (Revised);⁴ and
 - (ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects," or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:
- (a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and
 - (b) Include appropriate reference to this matter in the terms of the audit engagement.

³ HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

⁴ HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

Auditor's Report Prescribed by Law or Regulation

21. In some cases, law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of HKSA. In these circumstances, the auditor shall evaluate:
 - (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
 - (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.⁵

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with HKSA. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with HKSA.⁶ (Ref: Para. A38-A39)

Conformity and Compliance with International Standards on Auditing

22. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 210 *Agreeing the Terms of Audit Engagements*. Compliance with the requirements of this HKSA ensures compliance with ISA 210.
23. Additional local guidance and explanations are provided in footnotes 2a, 2b and 2c. An example audit engagement letter is provided in Appendix 1.

Application and Other Explanatory Material

Scope of this HKSA (Ref: Para. 1)

- A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics.⁷ The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in HKSA 220.⁸ This HKSA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

⁵ HKSA 706 (Revised)

⁶ See also HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 43.

⁷ *Hong Kong Framework for Assurance Engagements*, paragraph 17

⁸ HKSA 220, paragraphs 9-11

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

- A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users.⁹ Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the HKSAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.
- A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

- A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:
- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organization);
 - The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
 - The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
 - Whether law or regulation prescribes the applicable financial reporting framework.
- A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.
- A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. HKSA 800 (Revised) discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.¹⁰

⁹ *Hong Kong Framework for Assurance Engagements*, paragraph 19(b)(ii)

¹⁰ HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 8

- A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

- A8. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- International/ Hong Kong Financial Reporting Standards (IFRSs/ HKFRSs) promulgated by the International Accounting Standards Board/ the Hong Kong Institute of Certified Public Accountants;
- International Public Sector Accounting Standards (IPSASs) promulgated by the International Public Sector Accounting Standards Board; and
- Accounting principles promulgated by an authorized or recognized standards setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

- A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements for certain types of entities. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Jurisdictions that do not have standards setting organizations or prescribed financial reporting frameworks

- A10. When an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies a financial reporting framework to be applied in the preparation of the financial statements. Appendix 2 contains guidance on determining the acceptability of financial reporting frameworks in such circumstances.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

- A11. An audit in accordance with HKSA is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b).¹¹ In certain jurisdictions, such responsibilities may be specified in law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. HKSA do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit (including information obtained from outside of the general and subsidiary ledgers) in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.
- A12. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.
- A13. HKSA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities.¹² It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other HKSA and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.
- A14. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence.¹³ In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

- A15. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, *preparation* of the financial statements in accordance with the financial reporting framework includes *presentation*. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

¹¹ HKSA 200, paragraph A4

¹² HKSA 580, *Written Representations*, paragraphs 10-11

¹³ HKSA 580, paragraph A26

Internal Control (Ref: Para. 6(b)(ii))

- A16. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control.¹⁴
- A17. An independent audit conducted in accordance with the HKSAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.
- A18. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term "internal control" encompasses a wide range of activities within components that may be described as the control environment; the entity's risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.¹⁵ An entity's internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.
- A19. In some jurisdictions, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Additional Information (Ref: Para. 6(b)(iii)b.)

- A20. Additional information that the auditor may request from management for the purpose of the audit may include when applicable, matters related to other information in accordance with HKSA 720 (Revised). When the auditor expects to obtain other information after the date of the auditor's report, the terms of the audit engagement may also acknowledge the auditor's responsibilities relating to such other information including, if applicable, the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

- A21. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it

¹⁴ HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph A54

¹⁵ HKSA 315 (Revised), paragraph A59 and Appendix 1

may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

- A22. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

*Audit Engagement Letter or Other Form of Written Agreement*¹⁶ (Ref: Para. 10-11)

- A23. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some countries, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

- A24. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on HKSA 200.¹⁷ Paragraphs 6(b) and 12 of this HKSA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, HKSAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with HKSA 701.¹⁸
- The fact that 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.
- Arrangements regarding the planning and performance of the audit, including the composition of the engagement team.
- The expectation that management will provide written representations (see also paragraph A13).

¹⁶ In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

¹⁷ HKSA 200, paragraphs 3-9

¹⁸ HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

- The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures.
- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information¹⁹, if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

A25. When the auditor is not required to communicate key audit matters, it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

A26. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- A reference to, and description of, the auditor's responsibilities under law, regulation or relevant ethical requirements that address reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A27. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;
- Whether a separate auditor's report is to be issued on the component;

¹⁹ As defined in HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A28. If, in the circumstances described in paragraphs A23 and A29, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b). The accounting profession, audit standards setter, or audit regulator in a jurisdiction may have provided guidance as to whether the description in law or regulation is equivalent.

Considerations specific to public sector entities

A29. Law or regulation governing the operations of public sector audits generally mandate the appointment of a public sector auditor and commonly set out the public sector auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the public sector auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A30. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

- A31. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.
- A32. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.
- A33. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

- A34. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with HKSA's may need to assess, in addition to the matters referred to in paragraphs A31-A33 above, any legal or contractual implications of the change.
- A35. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:
- (a) The original audit engagement; or
 - (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

- A36. In some jurisdictions, law or regulation may supplement the financial reporting standards established by an authorized or recognized standards setting organization with additional requirements relating to the preparation of financial statements. In those jurisdictions, the applicable financial reporting framework for the purposes of applying the HKSA's encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition

to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards.²⁰

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

- A37. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of HKSA's (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

- A38. HKSA's require that the auditor shall not represent compliance with HKSA's unless the auditor has complied with all of the HKSA's relevant to the audit.²¹ When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of HKSA's and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with HKSA's. The auditor is, however, encouraged to apply HKSA's, including the HKSA's that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with HKSA's.

Considerations Specific to Public Sector Entities

- A39. In the public sector, specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if the entity attempts to limit the scope of the audit.

²⁰ HKSA 700 (Revised), paragraph 15, includes a requirement regarding the evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting framework.

²¹ HKSA 200, paragraph 20

Appendix 1

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 but do not 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 this HKSA. 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 [ABC Company Limited]:

Objective of services

- 1.1 You have requested that we audit the (consolidated)* financial statements of ABC Company 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 prepare (consolidated)* financial statements which give a true and fair view of the financial position of the Company (and its subsidiaries)* as at the end of the financial year and of [its][their] financial performance for the financial year in accordance with [insert applicable financial reporting framework] [Hong Kong Financial Reporting Standards][Hong Kong Financial Reporting Standard for Private Entities] and the Companies Ordinance ("CO");
 - b. (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 a. above.)*
 - c. 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)*, disclose with reasonable accuracy, at any time, the financial position and financial performance of the Company (and its subsidiaries)*;
 - d. 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);

- e. 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;
- f. To provide us with¹ :
 - (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;
- g. 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
- h. 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 [as well as the other information included in the annual report][#].

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 give a true and fair view of the financial position and financial performance of the Company (and its subsidiaries)* for the financial year 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 or 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 on directors' emoluments, etc 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.

¹ See paragraph A24 for examples of other matters relating to management's responsibilities that may be included.

- 3.2 We have a professional responsibility to report if the (consolidated)* financial statements do not comply in any material respect with *[insert applicable financial reporting framework]* *[Hong Kong Financial Reporting Standards]**[Hong Kong Financial Reporting Standard for Private Entities]*, unless in our opinion the noncompliance 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 give a true and fair view; 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 director's report and accordingly we will not express an opinion or review conclusion or any assurance on it.
- [3.4 We are required to read the other information included in the annual report. This responsibility applies regardless of whether the other information is made available to us prior to, or after, the date of the auditor's report. We will consider whether the other information is materially inconsistent with the (consolidated)* financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is an uncorrected material misstatement of this other information, we are required to include that fact in the auditor's report. Our opinion on the (consolidated)* financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon. If we conclude that a material misstatement exists in other information obtained after the date of the auditor's report and the other information is not corrected after communicating with those charged with governance, we will take appropriate actions considering our legal rights and obligations.][#]

Scope of audit

- 4.1 Our audit will be conducted in accordance with HKSAs 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.² 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

² This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

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.
 - e. Evaluate the overall presentation, structure and content of the (consolidated)* financial statements, including the disclosures, and whether the (consolidated)* financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- 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 HKSA's.
- (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 include the financial information of subsidiaries, joint arrangements or associates 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 chairman's statement, operating and financial review and 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

* 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.

applicable where the company prepares an annual report which contain other information in addition to the directors' report.

Appendix 2

(Ref: Para. A10)

Determining the Acceptability of General Purpose Frameworks

Jurisdictions that Do Not Have Authorized or Recognized Standards Setting Organizations or Financial Reporting Frameworks Prescribed by Law or Regulation

1. As explained in paragraph A10 of this HKSA, when an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies an applicable financial reporting framework. Practice in such jurisdictions is often to use the financial reporting standards established by one of the organizations described in paragraph A8 of this HKSA.
2. Alternatively, there may be established accounting conventions in a particular jurisdiction that are generally recognized as the financial reporting framework for general purpose financial statements prepared by certain specified entities operating in that jurisdiction. When such a financial reporting framework is adopted, the auditor is required by paragraph 6(a) of this HKSA to determine whether the accounting conventions collectively can be considered to constitute an acceptable financial reporting framework for general purpose financial statements. When the accounting conventions are widely used in a particular jurisdiction, the accounting profession in that jurisdiction may have considered the acceptability of the financial reporting framework on behalf of the auditors. Alternatively, the auditor may make this determination by considering whether the accounting conventions exhibit attributes normally exhibited by acceptable financial reporting frameworks (see paragraph 3 below), or by comparing the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable (see paragraph 4 below).
3. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:
 - (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.
 - (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
 - (c) Reliability, in that the information provided in the financial statements:
 - (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
 - (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
 - (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.

- (e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.
4. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to HKFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorized or recognized standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.
 5. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the particular jurisdictions by preparers and users.