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Effective for audits of financial statements
for periods ending on or after 15 December 2016

Practice Note 600.1 (Revised)

Reports by the Auditor under the Companies Ordinance (Cap. 622)



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

PRACTICE NOTE 600.1 (REVISED)
REPORTS BY THE AUDITOR UNDER
THE COMPANIES ORDINANCE (CAP. 622)

*(Issued June 2014; Revised December 2015; August 2016
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Practice Note (PN) 600.1 (Revised), *Reports by the Auditor under the Companies Ordinance (Cap. 622)* should be read in the context of the *Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* which sets out the application and authority of PNs.

**PRACTICE NOTE
600.1 (REVISED)
REPORTS BY THE AUDITOR UNDER
THE COMPANIES ORDINANCE (CAP. 622)**

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

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

Introduction

1. In this Practice Note all the sections mentioned below are in respect of the new Companies Ordinance (Cap. 622) ("CO") which became effective on 3 March 2014, unless otherwise stated. The new requirements apply to the first financial year¹ of companies that begins on or after the commencement date of the new CO and all subsequent financial years (i.e. typically the first set of financial statements covered would be for a financial period ending on or after 2 March 2015. Generally, for companies incorporated prior to 3 March 2014 with a calendar year end, the first applicable financial period is for the year ending 31 December 2015).
2. This Practice Note gives guidance on the application of Hong Kong Engagement Standards on reports by an auditor issued under the CO. It is applicable to all such reports, irrespective of whether the reporting entity has taken advantage of the reporting exemption available under the CO for companies which are eligible for those exemptions in accordance with section 359.²

Auditor's report

3. According to section 405 of the CO, a company's auditor must prepare a report for the members of the company on any financial statements prepared by the directors, a copy of which is laid before the company in general meeting under section 429, or sent to a member under section 430 or otherwise circulated, published or issued by the company, during the auditor's term of office.

Auditor's opinion on financial statements

4. Section 406(1) requires the auditor to state in the auditor's report, the auditor's opinion:
 - a. whether the financial statements have been properly prepared in compliance with the CO; and

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

² The new CO permits certain companies to take advantage of certain "reporting exemptions" if they meet the qualifying criteria set out in section 359 relating to small or larger eligible private companies (or groups), or small companies limited by guarantee (or groups).

The reporting exemptions available affect the content of the annual report. For example, these reporting entities are exempt from preparing a business review for the directors' report and may prepare their financial statements in accordance with the revised Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (SME-FRF and SME-FRS) which are effective for periods beginning on or after 3 March 2014.

However, in general, the reporting exemptions do not alter the duties of the auditor under the CO to make certain reports in certain circumstances. Therefore, unless otherwise stated, the guidance in this Practice Note applies to all such reports by the auditor, irrespective of whether the reporting entity has taken advantage of the reporting exemptions, in addition to the guidance in Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard*, which specifically relates to reporting on the financial statements under section 406 of the CO.

- b. in particular, whether the financial statements -
- i. in the case of annual financial statements of a company that does not fall within the reporting exemption³ for the financial year, give a true and fair view of the financial position and financial performance of the company as required by section 380; or
 - ii. in the case of annual consolidated financial statements of a company that does not fall within the reporting exemption for the financial year, give a true and fair view of the financial position and financial performance of the company and all the subsidiary undertakings as required by section 380.
5. In considering whether the financial statements give a true and fair view, it will be necessary for the auditor to take into account, inter alia, of the financial reporting framework adopted. Reference should be made to paragraph A13 of Hong Kong Standard on Auditing (HKSA) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, in respect of compliance with relevant requirements.
6. As explained in paragraph A13 of HKSA 200 where the financial reporting framework is a fair presentation framework, as is the case for statutory financial statements prepared by companies incorporated in Hong Kong which are not eligible for the reporting exemption, the opinion required by the HKSAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, as is the case for statutory financial statements prepared by companies incorporated in Hong Kong which are eligible for the reporting exemption, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework⁴.
7. The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:
- a. Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
 - b. Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in a. or b. above.

8. Normally, a company incorporated in Hong Kong prepares their financial statements in accordance with Hong Kong Financial Reporting Standards (HKFRSs) or Hong Kong Financial Reporting Standard for Private Entities (HKFRS for Private Entities) unless eligible for the reporting exemption. HKFRSs or HKFRS for Private Entities describe methods of accounting approved by the Council of the HKICPA for application to financial statements intended to give a true and fair view. If the company is eligible for the reporting exemption then it may prepare its financial statements in accordance with the Small and Medium-sized Entity Financial Reporting

³ As explained in footnote 2 above, if the reporting entity is eligible for the reporting exemption then it may prepare its financial statements in accordance with the SME-FRF and SME-FRS. Paragraph 1.2 of the SME-FRS requires those financial statements to properly present the financial position and financial performance of the reporting entity in accordance with the SME-FRS. This is consistent with the reporting exemption granted in section 380(7) of the CO. Consequently, the requirement under section 406(1)(b) for the auditors to report on whether the financial statements give a true and fair view does not apply when the auditor is reporting on financial statements prepared in accordance with the SME-FRF and SME-FRS. Further guidance on the auditor's report on financial statements prepared under the SME-FRF and SME-FRS is contained in Practice Note 900 (Revised).

⁴ Refer to Practice Note 900 (Revised) for further guidance on reporting on statutory financial statements prepared by reporting entities eligible for the reporting exemption.

Framework and Financial Reporting Standard (SME-FRF and SME-FRS), which is a compliance framework.

9. The auditor is also required to state whether, in the auditor's opinion, the financial statements have been properly prepared in compliance with the CO. In this context, the expression "properly prepared" includes compliance with the following requirements as set out in section 380 of the CO, in addition to an overriding requirement that the financial statements should give a true and fair view (if applicable):
 - a. The financial statements must comply with the requirements of accounting disclosures as set out in Schedule 4 of the CO.
 - b. The financial statements must also comply with -
 - i. any other requirements of the CO in relation to the financial statements; and
 - ii. the accounting standards applicable to the financial statements.
 - c. If, in relation to any financial statements that do not fall within the reporting exemption, compliance with a. and b. above would be insufficient to give a true and fair view, the financial statements must contain all additional information necessary for that purpose.
 - d. If, in relation to any financial statements that do not fall within the reporting exemption, compliance with a. or b. above would be inconsistent with a requirement to give a true and fair view, the financial statements must -
 - i. depart from a. or b. (as the case may be) to the extent necessary for it to give a true and fair view; and
 - ii. contain the reasons for, and the particulars and effect of, the departure.

10. An example of unmodified auditor's report for a company incorporated in Hong Kong and not falling within the reporting exemption is included in Appendix – Illustration 1 of HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*. A suggested Chinese translation of an unmodified auditor's report based on HKSA 700 (Revised) is provided on the HKICPA's website for reference. Examples of modified auditor's reports are included in the Appendix to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*. Examples of unmodified and modified auditor's reports for a company incorporated in Hong Kong which falls within the reporting exemption are included in the Appendices to Practice Note 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard*.

Auditor's opinion on directors' report

11. Section 406(2) states that if a company's auditor is of the opinion that the information in a directors' report for a financial year is not consistent with the financial statements for the financial year, the auditor -
 - a. must state that opinion in the auditor's report; and
 - b. may bring that opinion to the members' attention at a general meeting.

12. Section 406(2)(a) is silent on whether the provisions apply only to material inconsistencies. The auditor should refer to HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* for further guidance in this regard.

Auditor's opinion on other matters

13. In addition to the auditor's opinion on financial statements and director's report, an auditor is required to opine on other matters as set out in section 407 of the CO. These requirements include:
- a. In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to –
 - i. whether adequate accounting records have been kept by the company; and
 - ii whether the financial statements are in agreement with the accounting records.
 - b. A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that -
 - i. adequate accounting records have not been kept by the company; or
 - ii. the financial statements are not in agreement with the accounting records in any material respect.
 - c. If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
 - d. If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

The absence of any comment in the auditor's report in respect of these matters is equivalent to a positive affirmation by the auditor that he/ she is satisfied with each of them. If the auditor is not so satisfied, he/ she must state the fact in the auditor's report. The auditor should also refer to the guidance in paragraph 37 of AATB 4 "Guidance on section 408 of the Companies Ordinance".

14. In relation to paragraph 13.d. above, section 383(1) of the CO requires that the financial statements for a financial year must contain, in the notes to the statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G) ("Regulation") about the following:
- a. the directors' emoluments;
 - b. the directors' retirement benefits;
 - c. payments made or benefit provided in respect of the termination of the services of directors, whether in the capacity of directors or in any other capacity while directors;
 - d. loans, quasi-loans and other dealings in favour of -
 - i. directors of the company and of a holding company of the company;
 - ii. bodies corporate controlled by such directors⁵; and
 - iii. entities connected with such directors;
 - e. material interests of directors in transactions, arrangements or contracts entered into by

⁵ The auditor should read the Regulation when reporting on the above matters. According to section 13(5) of the Regulation, a reference is made to "a body corporate controlled by a director" within the meaning of section 492 of the CO.

the company or another company in the same group of companies;

- f. consideration provided to or receivable by third parties for making available the services of a person as director or in any other capacity while director.

Dating and signing of the auditor's report

- 15. Section 387(1) of the CO requires that a statement of financial position that forms part of any financial statements must be approved by the directors and signed by two directors on the directors' behalf or in the case of a company having only one director, by the director. The auditor should not sign or date the auditor's report earlier than the date on which the complete financial statements were approved by the director(s). The auditor shall sign and date the auditor's report on financial statements in accordance with paragraphs 47 and 49 of HKSA 700 (Revised).

Auditor's reports on consolidated financial statements

- 16. Under section 379(2) of the CO, if the company is a holding company at the end of the financial year, the directors must prepare for the financial year consolidated statements that comply with sections 380, 381 and 383. Sections 380 and 383 provide the general requirements for financial statements and notes to financial statements to contain information on directors' emoluments and section 381 deals with subsidiary undertakings to be excluded from the annual consolidated financial statements.
- 17. As stated in paragraph 4 above, the auditor is required to state in the auditor's report, the auditor's opinion:
 - a. whether the annual consolidated financial statements have been properly prepared in compliance with the CO; and
 - b. whether the annual consolidated financial statements of a company that does not fall within the reporting exemption for the financial year, give a true and fair view of the financial position and financial performance of the company and all the subsidiary undertakings as required by section 380.

As set out in paragraph 2, Part 1 of Schedule 4 of the CO, the annual consolidated financial statements must contain, in notes to the statements, the holding company's statement of financial position and must include a note disclosing the movement in the holding company's reserves. The holding company's statement of financial position must be in the format in which that statement would have been prepared if the holding company had not been required to prepare any annual consolidated financial statements. The holding company's statement of financial position to be contained in the notes to the annual consolidated financial statements is not required to contain any notes.

- 18. Examples of auditor's reports for companies incorporated in Hong Kong submitting consolidated financial statements are included in Appendix – Illustrations 2, 4 and 8 of HKSA 700 (Revised).
- 19. Normally, the auditor of a holding company incorporated in Hong Kong is required to report that the consolidated financial statements have been audited in accordance with HKSAs. HKSAs are approved by the Council of the HKICPA for application in the audit of historical financial information. It is stated in paragraph 36 of the Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements ("the Amended Preface") that where the financial statements of an overseas enterprise are to be incorporated into Hong Kong financial statements, the audit of the overseas enterprise should conform to HKSAs in so far as this is necessary to ensure that the audit of the Hong Kong financial statements as a whole is in accordance with HKSAs. It is also stated in paragraph 38 of the Amended Preface that where the financial statements of an overseas/ People's Republic of China incorporated enterprise which is listed on The Stock Exchange of Hong Kong Limited, the relevant Listing Rules allow the audit to conform to International Standards on Auditing.

20. Relevant guidance for audit of consolidated financial statements is included in HKSA 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

21. The following additional guidance is given in respect of modifications on consolidated financial statements:

a. *subsidiary company modification affecting consolidated financial statements*

Where the financial statements of a subsidiary contain a modification which is not eliminated on consolidation and is material to the consolidated financial statements, it will be necessary to consider whether it affects the consolidated financial position and the consolidated financial performance.

The auditor's report on the consolidated financial statements must be worded to include whatever reference is appropriate to the items which have been the subject of modification. However, it may not be adequate just to repeat the audit modification of the subsidiary's financial statements.

b. *modification of consolidated financial statements only*

Even though the auditor's reports of individual group companies may be unmodified, if the auditor concludes that a modification to the auditor's opinion on the consolidated financial statements is necessary, it may be necessary to modify the auditor's report on the consolidated financial statements.

Example modified auditors' reports on financial statements can be found in the Appendix to HKSA 705 (Revised) and in the Appendices to Practice Note 900 (Revised), as applicable.

Subsidiaries' and associates' financial statements audited by other auditors

22. The group auditor is fully responsible for the auditor's opinion on the consolidated financial statements. Section 412 of the CO⁶ empowers an auditor to require information and explanation for the performance of the duties as auditor from the following persons:

- a. an officer of the company;
- b. the subsidiary undertaking;
- c. a person who—
 - i. is an officer or auditor of the subsidiary undertaking; or
 - ii. was an officer or auditor of the subsidiary undertaking at the time to which the information or explanation relates; and
- d. a person who—
 - i. holds or is accountable for any of the subsidiary undertaking's accounting records; or
 - ii. held or was accountable for the subsidiary undertaking's accounting records at the time to which the information or explanation relates.

⁶ For further information, please refer to Companies Registry *Frequently Asked Questions* on Enhancement of Auditor's rights.

23. If a subsidiary undertaking of a company is not a company incorporated in Hong Kong, an auditor of the company may require the company to obtain from any of the persons specified in b. to d. above any information or explanation that the auditor reasonably requires for the performance of the duties as auditor of the company. In accordance with paragraph 11 of HKSA 600, the auditor's report on the consolidated financial statements shall not refer to the fact that the financial statements of some subsidiaries or associates have been audited by other auditors.
24. However, the directors of the holding company may consider it is useful to disclose the information that the financial statements of some of the entities in the group have been audited by other auditors and the materiality of those entities to the group. A common way to disclose this information is to include in the schedule of principal subsidiaries and associates, which of those entities have been audited by the other auditors. It may be useful to indicate thereon the significance to the group of the entities that have been so audited by reference to the amount of their assets, turnover or profits or losses before taxation.

Dates of financial statements of subsidiaries

25. In accordance with paragraph 37 of HKSA 600, if the consolidated financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the auditor of the holding company shall evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.
26. In accordance with paragraph B92 of Hong Kong Financial Reporting Standard 10 "Consolidated Financial Statements", when the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so. Paragraph B93 provides further guidance if it is impracticable for the subsidiary to prepare the financial information as required in paragraph B92. Similar guidance is set out in paragraph 9.16 of the HKFRS for Private Entities and paragraphs 19.8-19.9 of the SME-FRS, if applicable.

Identification of financial statements audited

27. Frequently one or more of the following accompany the financial statements in the company's annual report:
- a. directors' report;
 - b. chairman's statement; and
 - c. information supplementary to the financial statements.
28. In the absence of any separate reporting requirement (e.g. auditor's opinion on directors' report under section 406(2)), generally, the auditor is not responsible for the additional information referred to in paragraph 27 above. However, there could be a belief on the part of the reader that the auditor has in fact been satisfied that the information is accurate or at least not misleading. If the additional information is materially inconsistent or misleading, the auditor should determine whether the audited financial statements or the additional information needs to be revised before signing the auditor's report (see paragraphs 11-12 above and HKSA 720 (Revised)). Under HKSA 720 (Revised), the requirement is that if, on reading the other information, the auditor identifies a material inconsistency (or becomes aware that the other information appears to be materially misstated), the auditor shall determine whether the audited financial statements or the other information needs to be revised.
29. Generally, it is usual for the auditor to be specific as to the actual financial statements on which the auditor is opining on by identifying the page numbers containing the financial statements as follows (see A18 of HKSA 700 (Revised)):

"We have audited the financial statements of ABC Limited set out on pages to".

Other reports required by the Companies Ordinance

30. The CO also requires the auditor to give other reports on distributions and initial financial statements. The report arising under section 304(5) in relation to distributions is discussed in paragraphs 31 to 35 below. Guidance on the determination of distributable profits under sections 79A to 79P⁷ is set out in Accounting Bulletin 4 "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance" issued by the HKICPA and paragraphs 46 to 52 of the SME-FRF, if applicable. The report arising under section 306(5) in relation to initial financial statements is discussed in paragraphs 36 to 38 below.

Distributions (section 304(5))

31. The CO prohibits all companies from making a distribution otherwise than out of profits available for the purpose. Where the auditor has not given an unqualified opinion on the last annual financial statements, the company's ability to make a distribution, by reference to those financial statements, could be in doubt, and the company may not proceed to do so unless the auditor has made a statement under section 304(5) concerning the company's ability to make the distribution.
32. According to section 304(5) of the CO, the auditor must have given a written statement as to whether, in the auditor's opinion, the matter in respect of which the report is qualified⁸ is material for determining, by reference to the financial items as stated in the financial statements, whether the distribution would be made in contravention of section 297, 298 or 299 or a prohibition or restriction in that section as modified under section 300 of the CO. Therefore, in planning and performing this work, the auditor should refer to the principles in the Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* applicable to assurance engagements. The terms of this engagement should be agreed in writing with the company.
33. Although section 304(6)(a) allows the written statement to be made either at the time of the auditor's report or subsequently, in view of the two different standards involved (that is HKSAs in the auditor's report on annual financial statements and HKSAE 3000 (Revised) in the report under section 304(5)), a separate statement should be made for reporting under section 304(5) rather than reflecting in the auditor's report.
34. The auditor's statement under section 304(5) will incorporate the following elements:
- a. *Title* - The auditor's statement should have a title that clearly indicates that the report is an independent assurance report.
 - b. *Addressee* - the statement should be addressed to the members.
 - c. *Introductory Paragraph* - the auditor refers to the audit which will have been carried out in accordance with HKSAs issued by the HKICPA and state the date on which the auditor's opinion was expressed and that the auditor's opinion was modified. The auditor is required under section 304(5) to give a written statement as to whether, in the auditor's opinion, the matter in respect of which the auditor's opinion is modified is material for determining, by reference to the financial items as stated in the financial statements, whether the distribution would be made in contravention of section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300.

⁷ The guidance in AB 4 is still applicable for the CO. Sections 79A to 79P are replaced by sections 290 to 306 and Schedule 11, Part 6, section 49.

⁸ The meaning of "qualified" in the new CO is equivalent to the meaning of "modified" in the context of clarified HKSAs. In order to avoid confusion, the word "modified" is used in the rest of this Practice Note. Guidance on types of modified opinions is set out in HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

- d. *Directors' Responsibility* - this section describes and summarises the directors' responsibility with respect to the financial statements referred to in the introductory paragraph. The description should include an explanation that directors are also responsible for considering whether the company, subsequent to the reporting period, has sufficient distributable profits to make a distribution at the time the distribution is made.
- e. *Auditor's Responsibility* - the auditor should state that the auditor's responsibility is to report whether, in the auditor's opinion, the matter in respect of which the auditor's opinion is modified is material for determining, by reference to the financial items as stated in the financial statements, whether the distribution would be made in contravention of section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300. The auditor should state that the engagement was performed in accordance with HKSAE 3000 (Revised) and with reference to this Practice Note. The auditor should also include a summary of work performed to help the intended users understand the nature of the assurance conveyed by the assurance report.
- f. Independence and Quality Control – the auditor should state compliance with the independence and other ethical requirements of the Code of Ethics for Professional Accountants and the application of Hong Kong Standard on Quality Control 1, *Quality Control for Firms that perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.
- g. *Opinion* - the auditor must state whether in the auditor's opinion the matter in respect of which the auditor's opinion is modified is material for the purpose of determining, by reference to the financial items as stated in the financial statements, whether the distribution proposed by the company would contravene the relevant section(s) of the CO. A modification is not material for this purpose if the financial effect of the matters giving rise to modification could not be such as to reduce the distributable profits below the levels required for the purpose of such distributions. The level of the proposed or potential distribution should always be quantified in the opinion. Where the maximum effect of a modification is unquantifiable, it would normally be material for distribution purposes unless the auditor can conclude that the effect of the modification on the distributable profits could only be favourable. A disclaimer of opinion on the financial statements as a whole would be material as the auditor would be unable to form an opinion on the amount at which the company's distributable profits are stated.
- h. *Signature of the Auditor* - the auditor's statement should be signed in the name of the firm or the practitioner and a specific location, which ordinarily is the city where the practitioner maintains the office that has responsibility for the engagement.
- i. *Date of the independent assurance report* - the date used should be that on which the statement is signed. In any case the statement must be available to be laid before the company in general meeting before the distribution in question is made, and so the statement will have to be signed by that date.

An example of the independent assurance report under section 304(5) is set out as Example 1 in the Appendix.

- 35. The report under section 304(5) can only be made by the auditor who reported on the last annual financial statements.

Distributions by listed companies: the use of initial financial statements (section 306(5))

36. Paragraphs 31 to 35 of this Practice Note describe the statement required where a company wishes to make a distribution and a modified auditor's report has been given on the annual financial statements, section 304(5) applies to all types of companies (including private and listed companies). A company may wish to make a distribution during its first accounting reference period or after the end of that period but before the financial statements for that period have been laid before a general meeting. "Initial financial statements" must be prepared for this purpose which, in the case of a listed company, are required to satisfy section 306(2). The initial financial statements must be approved by and signed on behalf of the directors in the same manner as annual financial statements, and must be delivered to the Registrar of Companies.
37. Section 306(2) states that subject to subsection (3), the initial financial statements must:
- a. have been properly prepared in accordance with Subdivision 3 of Division 4 of Part 9 of the CO; or
 - b. have been properly prepared in accordance with Subdivision 3 of Division 4 of Part 9 of the CO, except only in relation to the matters which are not material for the purpose specified in subsection (8) (i.e. the purpose of determining, by reference to financial items as stated in the financial statements, whether the distribution would be made in contravention of section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300).

Subsection (3) states that the requirements under subsection (2) for the financial statements to be properly prepared has effect subject to any modifications that are necessary for applying that requirement to any financial statements prepared otherwise than for a financial year.

38. The reference to Subdivision 3 of Division 4 of Part 9 of the CO in sections 306(2) and 306(3) indicates that the initial financial statements should be properly prepared so as to give a true and fair view of the company's financial position and performance and to comply with Schedule 4, subject to any modifications that are necessary for applying that requirement to any financial statements prepared otherwise than for a financial year. However, it should also be noted that the alternative offered in section 306(2)(b) allows a company to prepare initial financial statements which do not meet all of these requirements, provided that the information omitted is not material for the purpose of determining the legality of the proposed distribution. For example, if a listed company applies section 306(2)(b), the initial financial statements may omit some of the disclosure requirements of HKFRSs. In the case of a listed company, the auditor is required to make a report on the initial financial statements. The report will incorporate the following elements:
- a. *Title* - The auditor's report should have a title that clearly indicates that it is the report of an independent auditor.
 - b. *Addressee* - the report should be addressed to the members.
 - c. *Auditor's Opinion* - the auditor must state whether, in the auditor's opinion, the financial statements satisfy section 306(2)(a). This therefore means that the auditor must report on whether in the auditor's opinion the financial statements give a true and fair view of the financial position of the company as at the end of the reporting period and of the financial performance of the company for the reporting period, and on whether the financial statements comply with Schedule 4 subject to any modifications that are necessary for applying that requirement to any financial statements prepared otherwise than for a financial year. An example of an unqualified auditor's report prepared in accordance with section 306(2)(a) is set out as Example 2 in the Appendix.

If the opinion is modified (for example, if the company has chosen to prepare financial statements which comply with section 306(2)(b) rather than section 306(2)(a)), then section 306(6) requires the auditor to state whether the matter giving rise to the modification is material for determining whether the distribution is permitted. In addition, a separate statement (see Example 1 in the Appendix) should be made for reporting under section 306(6) rather than reflecting in the auditor's report. Guidance on elements of the auditor's report in paragraph 34 above is also applicable to such an auditor's statement to be given under section 306(6).

This section should also state that the report is concerned with the initial financial statements. The period covered by the initial financial statements and the accounting principles adopted should be identified.

- d. *Basis for Opinion* - the same principles apply for initial financial statements as for annual financial statements (see HKSA 700 (Revised)).
- e. *Key Audit Matters* - for audits of the initial financial statements, the auditor should communicate key audit matters in the auditor's report in accordance with HKSA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.
- f. *Other information* - where applicable, the auditor should report in accordance with HKSA 720 (Revised).
- g. *Responsibilities of Directors and Those Charged with Governance for the Initial Financial Statements*- the directors are responsible for the preparation of initial financial statements under section 306. This section should also identify those responsible for the oversight of the financial reporting process, details should refer to HKSA 700 (Revised).
- h. *Auditor's Responsibilities for the Audit of the Initial Financial Statements* - the auditor is responsible for expressing an opinion on whether the initial financial statements satisfy section 306(2)(a). The audit of the initial financial statements should be carried out in accordance with HKSAs. The auditor shall explain the auditor's responsibilities as described in paragraphs 37 to 40 of HKSA 700 (Revised).
- i. *Name of the Engagement Partner* – this should be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities.
- j. *Signature of the Auditor* - the auditor's report should be signed (see footnote 36a of HKSA 700 (Revised)).
- k. *Date of the Auditor's Report* - the same principles apply for initial financial statements as for annual financial statements (see HKSA 700 (Revised)).

APPENDIX
**Example reports in relation to sections 304(5) and 306(5) of
the Companies Ordinance**

The purpose of this Appendix is to provide examples of reports and is for illustration.

- 1 Independent auditor's assurance report on a company's ability to make a distribution where auditor's opinion was modified - based on HKSAE 3000 (Revised)
- 2 Independent auditor's report on initial financial statements prepared in accordance with section 306(2)(a) when a listed company wishes to make a distribution - based on HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Example 1 – Independent auditor's assurance report on a company's ability to make a distribution where auditor's opinion was modified, based on HKSAE 3000 (Revised)

INDEPENDENT AUDITOR'S ASSURANCE REPORT UNDER SECTION 304(5)¹ OF THE COMPANIES ORDINANCE

To the Members of XYZ Limited

We have audited the financial statements of XYZ Limited ("the Company") for the year ended 31 December 20X1 in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have expressed a modified opinion thereon in our independent auditor's report dated [date]. Under section 304(5) of the Companies Ordinance ("the Ordinance"), we have been requested to give this written statement as to whether, in our opinion, the matter in respect of which our opinion is modified is material for the purpose of determining, by reference to the financial items as stated in the financial statements, whether the distribution would be in contravention of the [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance.

Directors' Responsibility

The directors are responsible for the preparation of the aforesaid financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the HKICPA and the Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. They are also responsible for considering whether the Company, subsequent to the year ended 31 December 20X1, has sufficient distributable profits to make a distribution at the time the distribution is made.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the HKICPA, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1³ and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Auditor's Responsibility

Our responsibility is to report whether, in our opinion, the matter of our modification of our auditor's report on the financial statements for the year ended 31 December 20X1 is material for the purpose of determining, by reference to the financial items as stated in the financial statements, whether the distribution proposed by the Company would contravene [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance.⁴ However, we are not required to form an opinion on whether the Company has sufficient distributable reserves to make the distribution proposed at the time it is made.

¹ Section 304(5) applies where the last annual financial statements are used. Where initial financial statements are used a similar report is prepared based on the report in Example 2 of this Appendix.

² Amend where appropriate.

³ HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

⁴ 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 "Auditor's Duty of Care To Third Parties and The Audit Report".

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 600.1 (Revised), *Reports by Auditor under the Companies Ordinance* issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving our opinion below.

We have planned and performed such procedures as we considered necessary to evaluate the effect of the modified opinion for the determination of profits available for distribution. [*Insert a summary of work performed.*]

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

Opinion

Based on the foregoing, in our opinion, the matter of the modification is not material for determining, by reference to the financial items as stated in the financial statements, whether the [distribution of HK\$.....][interim/ final dividend for the year ended 31 December 20X1 of HK\$] proposed by the Company would contravene [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance.

Intended Users and Purpose

This report is intended solely for the purpose of assisting the Company to satisfy the requirements of the Ordinance as set out in the introductory paragraph. It is not intended to be, and should not be, used by anyone for any other purpose.

ABC & Co.

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

[*Auditor's Address*]

Date

Notes:

1. As an alternative the auditor's statement might be expressed in terms of the company's ability to make potential distributions up to a specific level. This may be particularly appropriate where the directors have only determined the maximum level of distributions. In such circumstances the opinion paragraph would be worded as follows:

"Based on the foregoing, in our opinion, the matter of the modification is not material for determining, by reference to the financial items as stated in the financial statements, whether a distribution of not more than HK\$ by the Company would contravene [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance."

2. As a further alternative the auditor's statement might be expressed in terms of the company's ability to make "any distribution". In such circumstances the opinion paragraph would be worded as follows:

"Based on the foregoing, in our opinion, the matter of the modification is not material for determining by reference to the financial items as stated in the financial statements, whether any distribution proposed by the Company would contravene [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance."

3. Where the auditor concludes that the matter of the modification is material to either a specific distribution which is proposed or to any distribution, then an adverse opinion is given. In such circumstances the opinion paragraph would be worded as follows:

"Adverse opinion

Based on the foregoing, in our opinion, the matter of the modification is material for determining, by reference to the financial items as stated in the financial statements, whether the [distribution of HK\$.....][interim/ final dividend for the year ended 31 December 20X1 of HK\$][any distribution] proposed by the Company would contravene [section 297, 298 or 299, or a prohibition or restriction in that section as modified under section 300]² of the Ordinance."

Example 2 – Independent auditor's report on initial financial statements prepared in accordance with section 306(2)(a) when a listed company wishes to make a distribution - based on HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

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

- Audit of a complete set of financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.¹
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised)².
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Companies Ordinance.

**INDEPENDENT AUDITOR'S REPORT
UNDER SECTION 306(5) OF THE COMPANIES ORDINANCE**

To the Members of XYZ Limited

Opinion

We have audited the initial financial statements of XYZ Limited ("the Company") set out on pages to, which comprise the statement of financial position as at [Date], and [the statement of profit or loss and]³ the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the period from [Date] to [Date], and notes to the financial statements including a summary of significant accounting policies.

In our opinion, the initial financial statements give a true and fair view of the financial position of the Company as at [Date], and of its financial performance and its cash flows for the period from [Date] to [Date] in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Companies Ordinance.

¹ HKSA 210, *Agreeing the Terms of Audit Engagements*

² HKSA 570 (Revised), *Going Concern*

³ HKAS 1 (Revised) allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income").

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSA") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Initial Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the initial financial statements. These matters were addressed in the context of our audit of the initial financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with HKSA 701.]

Other Information [or another title if appropriate such as "Information Other than the Initial Financial Statements and Auditor's Report Thereon"]

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

Responsibilities of Directors and Those Charged with Governance for the Initial Financial Statements⁴

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

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

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

Auditor's Responsibilities for the Audit of the Initial Financial Statements

Our objectives are to obtain reasonable assurance about whether the initial 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.⁵ Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSA will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSA expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this

⁴ Throughout the illustrative auditor's reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

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 "Auditor's Duty of Care To Third Parties and The Audit Report".

material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

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

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

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

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the initial financial statements and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

ABC & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]