

TECHNICAL NOTE 02/2006 – MODIFIED AUDITOR’S REPORT

Paul Yeung [October 2006]

HKSA 701 “Modifications to the Independent Auditor’s Report”

The HKICPA has issued a new auditing standard HKSA 701 “Modifications to the Independent Auditor’s Report”.

HKSA 701 is effective for auditor’s reports dated **on or after 31 December 2006**.

HKSA 701 establishes standards and provides guidance on the modifications to the auditor’s report for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion.

Major changes from the previous requirements are as follows:

- the concept of fundamental uncertainty is removed;
- consistent with the requirements of HKSA 570 “Going Concern”, the auditor’s report should be modified by adding a paragraph (“an emphasis of matter paragraph”) to highlight a material matter regarding a going concern problem;
- the auditor should consider modifying the auditor’s report by adding an emphasis of matter paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements;
- an emphasis of matter paragraph (whether for a material matter regarding a going concern problem, for a significant uncertainty other than a going concern problem, or for matters other than those affecting the financial statements) would preferably be included after the paragraph containing the auditor’s opinion (but before the section on any other reporting responsibilities, if any);
- the new threshold for issuing an adverse opinion is “the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements”. [The previous threshold is “seriously misleading”];
- unless impracticable [the previous guidance is “whenever practicable”], a quantification of the possible effect(s) on the financial statements should be included in the auditor’s report whenever the auditor expresses an opinion that is other than unqualified [“other than unqualified” refers to qualified opinion, adverse opinion and disclaimer of opinion and does not include an emphasis of matter.];
- Examples in the Appendix use the new sub-headings of “Basis for qualified opinion”, “Basis for adverse opinion” and “Basis for disclaimer of opinion”;

- When there is a limitation on the scope leading to a qualified opinion or a disclaimer of opinion,
 - i. the wording like “Except as discussed in the following paragraph,” should be included in the paragraph of auditor’s responsibilities;
 - ii. the auditor’s report should indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed;
 - iii. in the case of a disclaimer of opinion,
 - 1) the wording like “We were engaged to audit” instead of the wording “We have audited ...” should be used in the introductory paragraph; and
 - 2) the wording like “However, because of the matter described in the basis for disclaimer of opinion paragraph, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.” should be included in end of the paragraph of auditor’s responsibilities.

Examples of auditor’s report are as follows:

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|-----------|----------------------------------------------------------------------------------------------------|
| Example 1 | Modified by an emphasis of matter paragraph
– material matter regarding a going concern problem |
| Example 2 | Modified by an emphasis of matter paragraph
– significant uncertainty |
| Example 3 | Qualified opinion – disagreement with management |
| Example 4 | Qualified opinion – limitation on the auditor’s work |
| Example 5 | Disclaimer of opinion – limitation on the auditor’s work |
| Example 6 | Adverse opinion – disagreement with management |

Example 1 Modified by an emphasis of matter paragraph
 – material matter regarding a going concern problem

INDEPENDENT AUDITOR' S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Without qualifying our opinion, we draw attention to Note 10 in the financial statements which indicates that the Company incurred a net loss of ABC Limited during the year ended 31 December 2006 and, as of that date, the Company's current liabilities exceeded its total assets by HK\$1,000,000. These conditions, along with other matters as set forth in Note 10, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007

Example 2 Modified by an emphasis of matter paragraph
– significant uncertainty

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TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Without qualifying our opinion we draw attention to Note 10 to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007

Example 3 – Qualified opinion – disagreement with management

INDEPENDENT AUDITOR' S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

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

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

Basis for qualified opinion

Included in debtors shown on the balance sheet is an amount of \$1,000,000 due from a debtor which has ceased trading. ABC Limited has no security for this debt. On the basis that no security has been obtained and no cash has been received on the debt, in our opinion the company should make a full provision for impairment of \$1,000,000 reducing profit before taxation for the year and net assets at 31 December 2006 by that amount.

Qualified opinion arising from disagreement about accounting treatment

In our opinion, except for the effect on the financial statements of the matter described in the basis for qualified opinion paragraph, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007

Example 4 – Qualified opinion – limitation on the auditor' s work

INDEPENDENT AUDITOR' S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Except for the limitation in the scope of our work as explained in the basis for qualified opinion paragraph, we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

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

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

Basis for qualified opinion

A total of HK\$1,000,000 of the company's recorded turnover comprises cash sales, over which there was no system of internal control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to satisfy ourselves that the recorded turnover was free from material misstatements.

Qualified opinion arising from limitation of audit scope

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to cash sales, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

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

In respect alone of the limitation on our work relating to cash sales, we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and we were unable to determine whether proper books of account had been kept.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007

Example 5 – Disclaimer of opinion – limitation on the auditor' s work

INDEPENDENT AUDITOR' S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We were engaged to audit the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Except for the limitation in the scope of our work as explained in the basis for disclaimer of opinion paragraph, we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement. However, because of the matter described in the basis for disclaimer of opinion paragraph, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

We were initially appointed auditors on 1 March 2007 which was subsequent to the end of the company's financial year. In consequence we were unable to carry out auditing procedures necessary to obtain adequate assurance regarding the quantities and condition of inventories and work in progress, appearing in the balance sheet at \$1,000,000. There were no other satisfactory audit procedures that we could adopt to obtain sufficient evidence regarding the existence of inventories and work in progress. Accordingly, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Any adjustment to the figure

may have a consequential significant effect on the profit for the year and net assets at 31 December 2006.

Disclaimer of opinion: disclaimer on view given by financial statements

Because of the significance of the matters described in the basis for disclaimer of opinion paragraph, we do not express an opinion on the financial statements as to whether they give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

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

In respect alone of the limitation on our work relating to cash sales, we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and we were unable to determine whether proper books of account had been kept.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007

Example 6 – Adverse opinion – disagreement with management

INDEPENDENT AUDITOR' S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages [x] to [x], which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 141 of the Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

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

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

Basis for adverse opinion

As more fully explained in note 10 to the financial statements, losses expected to arise on certain long term contracts currently in progress have not been recognised as expenses, as the directors consider that such losses should be off-set against amounts recoverable on other long-term contracts. In our opinion, the expected losses on individual contracts should be recognised as expenses immediately as required by Hong Kong Accounting Standard 11 "Construction Contracts". If losses had been so recognised the effect would have been to reduce the profit before taxation for the year and reduce the gross amounts due from customers at 31 December 2006 by HK\$1,000,000.

Adverse opinion

In our opinion, because of the significance of effects of the matters described in the basis for adverse opinion paragraph, the financial statements do not give a true and fair view of the state of the company's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

PKF

Certified Public Accountants

Hong Kong, 31 March 2007