

Presented by: Karen Mak

Senior Manager, PricewaterhouseCoopers

Date:

8 January 2020

**“CPA for NGO”
Social Responsibility Programme**

**Understanding Financial Statements
and Auditors’ Reports**



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

Disclaimer

- The Hong Kong Institute of Certified Public Accountants, PricewaterhouseCoopers and the speaker do not accept any responsibility or liability in respect of the contents of the update and disclaim any responsibility and liability in relation to this workshop and any consequences that may arise from any person acting or refraining from action as a result of any material associated with the update. Any reliance on the material associated with the update is solely at the user's risk. Before making any decision or taking any action, you should read the applicable professional standards in full.



Agenda

1. Laws and requirements on financial statements and audits
2. Understanding financial statements
3. Financial statements analytics
4. Understanding auditors' reports



1. Laws and requirements on financial statements and audits



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

1. Laws and requirements on financial statements and audits

- a) By Governing Instruments
- b) By Law
- c) By Funding Bodies, Government Departments and Other Organisations



1. Laws and requirements on financial statements and audits

a) By Governing Instruments

- Commonly used structures include i) a **trust**, ii) a **society** established under the Societies Ordinance (Cap. 151), iii) a **company** incorporated under the Companies Ordinance (Cap. 622); and iv) a **statutory body** established by the Hong Kong legislature.
- There can be situations that written governing instruments impose requirements on audited financial statements in **addition to the prevailing laws**.



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622) 《公司條例》

- A company's directors must prepare for each financial year (consolidated) financial statements that **give a true and fair view** (真實而公平的反映) of the **financial position** (財務狀況) of the company (and its subsidiary undertakings) as at the end of the financial year and their **financial performance** (財務表現) for the financial year (section 379 (1) and (2)).
- The financial statements for a financial year must comply with i) any other requirements of this Ordinance in relation to the financial statements; and (ii) the **accounting standards applicable to the financial statements** (財務報告準則).
- The **HKICPA** is the body prescribed in the Companies (Accounting Standards (Prescribed Body)) Regulation for issuing or specifying the applicable accounting standards.



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622) 《公司條例》

- The HKICPA issues **three sets** of financial reporting standards:
 - Hong Kong Financial Reporting Standards (“HKFRS”) 《香港財務報告準則》 that gives a **true and fair view**
 - Hong Kong Financial Reporting Standards for Private Entities (“HKFRS for Private Entities”) 《私營企業香港財務報告準則》 that gives a **true and fair view**
 - Small and Medium-Sized Entity Financial Reporting Standards (“SME-FRS”) 《中小企財務報告準則》 that do **not** give a **true and fair view**
- SME-FRS, the accounting standards applicable to companies that **fall within the reporting exemption** and **prepares simplified financial reports** are **less onerous than HKFRS.**



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- SME-FRS: Reporting exemption

The qualifying criteria for companies reported under SME-FRS are summarised in

<https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Our-views/Standards-Interpretations-Guides-and-PN-Members-Handbook/Reference-Materials/SME-Financial-Reporting-Framework-and-Standard/smeffre2019>



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- SME-FRS: Reporting exemption

Eligible categories	Size test
Small company limited by guarantee	The total annual revenue of the small company limited by guarantee must not exceed HK\$25 million .
A group of small companies each limited by guarantee which may include non-Hong Kong body corporates	<ul style="list-style-type: none">a) Each company in the group must qualify as a small company limited by guarantee;b) Each non-Hong Kong body corporate in the group (if any) would have been qualified as a small company limited by guarantee for the financial year had it been incorporated under the new Companies Ordinance; andc) The aggregate annual revenue of the group must not exceed HK\$25 million

1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- SME-FRS: Reporting exemption

(provided that both the holding company and all of its subsidiaries meet the specified size criteria)

Eligible categories	Size test
If the holding company is a small private company	<u>Any 2 conditions below should be met:</u> 1. Aggregate total revenue not exceeding HK\$100M 2. Aggregate total assets not exceeding HK\$100M 3. Aggregate employees not exceeding 100

Reference:

https://www.cr.gov.hk/en/companies_ordinance2018/docs/Pam_38E.pdf



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- SME-FRS: Reporting exemption

Eligible categories	Size test
If the holding company is an eligible private company (with members' approval)	<u>Any 2 conditions below should be met:</u> 1. Aggregate total revenue not exceeding HK\$200M 2. Aggregate total assets not exceeding HK\$200M 3. Aggregate employees not exceeding 100 ♦ For a group of eligible private companies, the adoption of simplified reporting will require a resolution by members of the holding company
If the holding company is a small guarantee company	<u>The following condition should be met:</u> Aggregate total revenue not exceeding HK\$25M



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- SME-FRS: Reporting exemption
 - The exemptions relating to preparation of financial statements:
 - No requirement to disclose auditor's remuneration in financial statements
 - **No requirement** for financial statements to **give a true and fair view**
 - **Subsidiary undertakings may be excluded** from consolidated financial statements in accordance with applicable accounting standards
 - No requirement for auditor to express a true and fair view opinion on the financial statements



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- **Audit** of the financial statements is required for **all companies except dormant companies**.
- Companies **limited by guarantee** are required to **hold its annual general meeting** each financial year **within nine months after the end of the financial year** and have its **audited financial statements laid** before the members in that **annual general meeting** (section 429(1)).



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- A director commits an offence and is liable to a fine of \$300,000 if he or she fails to take all reasonable steps to secure compliance with true and fair view on financial statements under section 379(1) or (2).
- A director commits an offence and is liable to a fine of \$300,000 and to imprisonment for 12 months if he or she wilfully fails to take all reasonable steps to secure compliance with true and fair view on financial statements under section 379(1) or (2).



1. Laws and requirements on financial statements and audits

b) By Law

i) Companies Ordinance (Cap. 622)

- **A director** commits an **offence** and is liable to a fine of **\$300,000** if he or she **fails to take all reasonable steps to secure compliance with the requirement to have audited financial statements laid before an annual general meeting** held within 9 months from the end of the financial year under section 429(1).
- A director commits an offence and is liable to a fine of **\$300,000** and to **imprisonment for 12 months** if he or she **wilfully fails to take all reasonable steps to secure compliance with the requirement to have audited financial statements laid before an annual general meeting** held within 9 months from the end of the financial year under section 429(1).



1. Laws and requirements on financial statements and audits

b) By Law

ii) Societies Ordinance (Cap. 151)

- No particular requirement on audit of financial statements.



1. Laws and requirements on financial statements and audits

c) By Funding Bodies, Government Departments and Other Organisations

i) Funding bodies

- By terms contained in **contracts, agreements, letters**
- Some even require **additional audit or other opinions** on other areas in addition to the audited financial statements such as i) **compliance with terms** of contracts, guidelines and requirements and ii) in separate report on **internal control**

ii) Government Departments

- **Submission of accounts** on **application** and call for accounts **from time to time** by the Inland Revenue Department for charitable institutions or trusts of a public character that are exempt from tax under section 88 of the Inland Revenue Ordinance



1. Laws and requirements on financial statements and audits

c) By Funding Bodies, Government Departments and Other Organisations

iii) Other Organisations

- Requirements after becoming **member bodies** of certain organisations such as one set out in the Constitution of The Hong Kong Council of Social Service as follows:
 - Clause 12(b): Submit copies of **audited accounts** or **certified accounts** with regards to annual income and expenditure after the end of their financial year



2. Understanding financial statements



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

What's the difference between management accounts and financial statements?

	Management Accounts	Financial Statements
Purpose	Decision making	Communication of financial position
Requirement	Optional	Mandatory
Primary Users	Internal users: management, decision makers	External users: government, donors, beneficiaries/ members, the public
Regulation/guidelines	None	HKFRS, HKFRS for Private Entities, SME-FRS
Frequency	As frequently as needed	At least annually
External review	No independent audits	Audited by Certified Public Accountants (CPA)
Focus	Information to aid decisions for the future	Past transactions



Who has the responsibility for preparing the annual financial statements?

- a) Directors
- b) Senior management
- c) Accounts/Finance department
- d) Auditor

Answer: A - Directors



Who has the responsibility for preparing the annual financial statements?

Companies Ordinance (Cap. 622) – section 379(1) and (2)

- A company's **directors must prepare** for each financial year (consolidated) statements that comply with sections 380, 381 and 383.
- 公司的**董事**須就每個財政年度**擬備**符合第380、381及383條的(綜合)報表。



2. Understanding financial statements

a) Conceptual Framework for Financial Reporting (財務報告概念框架)

- A basic document that sets **objectives** and the **concepts** for general purpose financial reporting.
- Framework is **NOT a Standard** itself.
- The HKICPA has issued a revised Conceptual Framework in 2018 which will be effective from **1 January 2020**.



2. Understanding financial statements

a) Conceptual Framework for Financial Reporting - Objective

To provide financial information that is useful to users in **making decisions** relating to providing resources to the entity

Users of the financial statements

Government

Donors

Beneficiaries/
members

The public

Users' decisions involve decisions about

whether money is being spent on their real needs

whether activities are going ahead as planned

whether the NGO achieves its missions and visions

whether the NGO has enough funds for the future

To make these assessments, users need information about both

the entity's economic resources, claims against the entity and changes in those resources and claims

how efficiently and effectively management has discharged its responsibilities to use the entity's economic resources

2. Understanding financial statements

a) Conceptual Framework for Financial Reporting - Objective

Accrual accounting

the events should be reflected in the reports in the periods when the effects of transactions occur, regardless the related cash flows.

Past cash flows

However, the information about past cash flows is very important to analysis the use of funds and to assess whether the NGO has sufficient cash flows to meet future needs.

2. Understanding financial statements

What's the difference between Cash Basis Accounting and Accrual Basis Accounting?

Cash Basis	Accrual Basis
<ul style="list-style-type: none">Revenue is recorded when cash is receivedExpenses are recorded when cash is paidNo outstanding or prepaid expenses, accrued income, income received in advance in the Balance SheetDoes not follow the Hong Kong accounting standards	<ul style="list-style-type: none">Revenue is recognised when earnedExpenses are recorded when incurredThere may be outstanding or prepaid expenses, accrued income, income received in advance in the Balance SheetFollows the Hong Kong accounting standards

2. Understanding financial statements

a) Conceptual Framework for Financial Reporting – Qualitative Characteristics

For information to be useful it must both be **relevant** and provide a **faithful representation** of what it purports to represent

Fundamental qualitative characteristics

Relevance (materiality)

- information is **relevant** if it is capable of making a difference to the decisions made by users
- financial information is capable of making a difference in decisions if it has predictive value or confirmatory value

Faithful representation

- information must **faithfully represent** the substance of what it purports to represent
- a faithful representation is, to the maximum extent possible, complete, neutral and free from error
- a faithful representation is affected by level of measurement uncertainty

2. Understanding financial statements

a) Conceptual Framework for Financial Reporting – Qualitative Characteristics

Enhancing qualitative characteristics

Comparability

Verifiability

Timeliness

Understandability

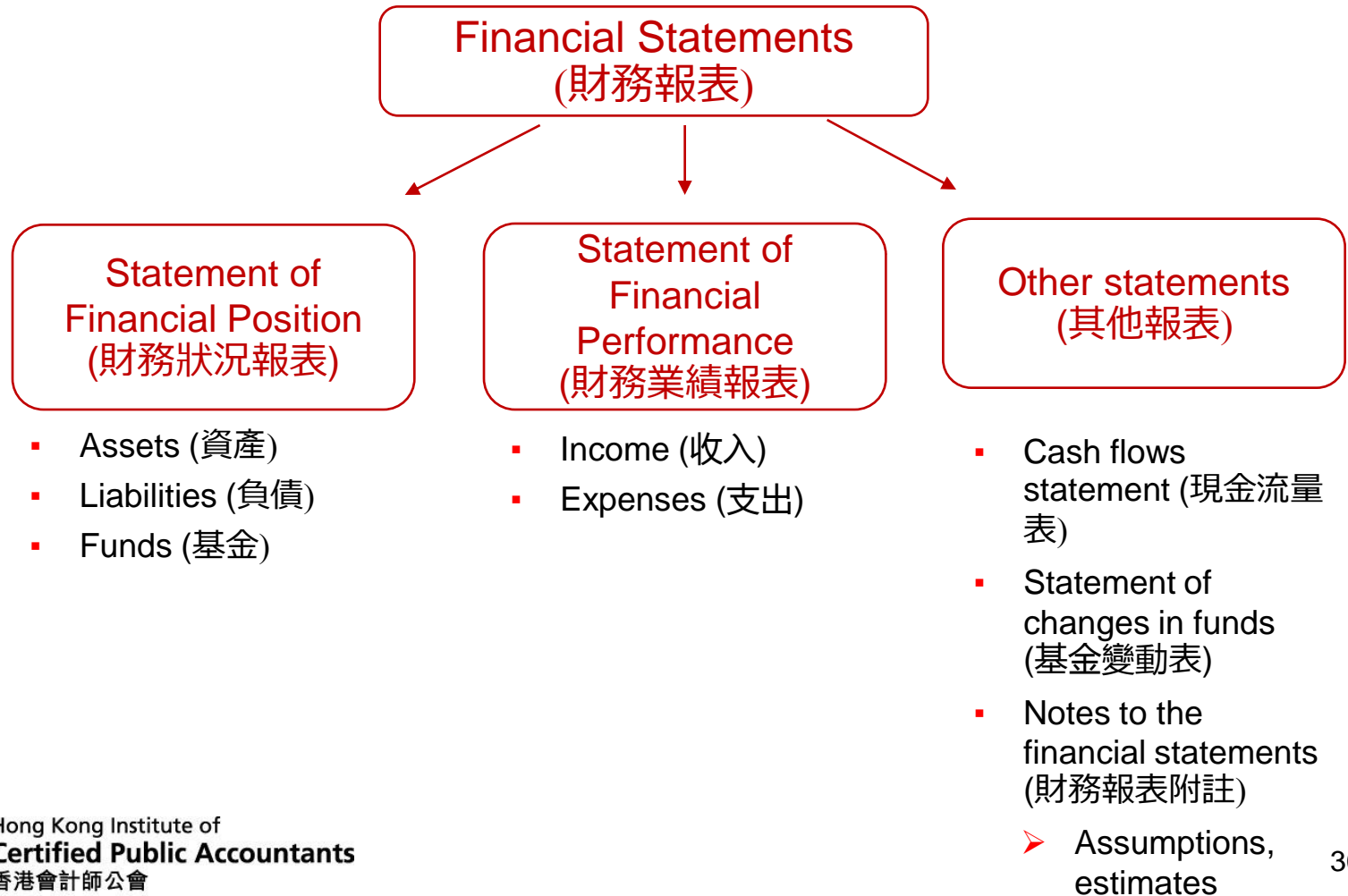
- these four qualitative characteristics enhance the usefulness of information
- but they cannot make non-useful information useful

Cost constraint

- the benefit of providing the information needs to justify the cost of providing and using the information

2. Understanding financial statements

a) Conceptual Framework for Financial Reporting – Financial Statements



2. Understanding financial statements

a) Conceptual Framework for Financial Reporting – Financial Statements

Going concern assumption (持續營運能力)

- The financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the foreseeable future.
- Conversely, this also means the organization will not be forced to cease its operating and programmatic activities and liquidate its assets in the near term.
- The **going concern principle is presumed** as the basis for preparing financial statements - unless and until the organization's liquidation becomes imminent.
- If and when an organization's **liquidation does become imminent**, financial statements should be prepared **using the liquidation basis**.

2. Understanding financial statements

a) Framework for Financial Reporting – Elements of Financial Statements

Economic resources
(經濟資源)

Assets
(資產)

- A **present economic resource** controlled by the entity as a result of **past events**.
- An economic resource is a **right** that has **the potential to produce economic benefits**.

Claim
(索償)

Liabilities
(負債)

- A **present obligation** of the entity to **transfer an economic resource** as a result of **past events**.

Funds
(基金)

- The **residual interest in the assets** of the entity after **deducting all its liabilities**.

2. Understanding financial statements

a) Framework for Financial Reporting – Elements of Financial Statements

Changes in
economic
resources
and
claims,
reflecting
financial
performance

Income
(收入)

- Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses
(支出)

- Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Other
changes in
economic
resources
and
claims

- Contributions from holders of equity claims, and distributions to them.
- Exchanges of assets or liabilities that do not result in increases or decreases in equity.

2. Understanding financial statements

b) Core Statements at a Glance

- Appendix 1: Core Statements at a Glance
 - Statement of Financial Position (財務狀況報表)
 - Statement of Profit or Loss (財務業績報表)
 - Statement of Changes in Funds (基金變動表)
 - Statement of Cash Flows (現金流量表)



3. Financial statements analytics



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

3. Financial statements analytics

a) General Principles

- “Analytical procedures” mean the analysis of significant **ratios and trends** including the resulting **investigation of fluctuations and relationships** that are **inconsistent with other relevant information or deviate from predicted amounts.**”
- Single ratio is **not meaningful by itself** and must be examined in context of the company’s **past performance, the sector, major competitors and the economy.**
- Ratios are designed to provide analyst with **pertinent questions (like why?, what? and how?) to assist in conducting the analysis** of the company.



3. Financial statements analytics

b) Analytical procedures

- **Variance analyses** compare **actual with predicted amounts** in the form of **absolute or relative** differences in percentage terms.
- **Predicted amounts** include **prior period amounts, anticipated results** and **similar sector information**.
- **Degree of disaggregation** need to be determined.
- **Thresholds** (in dollar and percentage terms) should be established for **investigative and follow-up actions**.
- **Explanations and causes** are important to be obtained.
- There can be potential **adjustments to budgets** and even **changes to business or economic decisions**.



3. Financial statements analytics

c) Common-Size Statements (共同比財務報表)

- Evaluates financial statements by expressing each line item as a percentage of the base amount for that period.
- Looking at the numbers on the financial statement as a percentage of a total rather than their absolute value.



3. Financial statements analytics

c) Common-Size Statements

- Examples:

Common size statement of financial position					
	<u>2018</u>		<u>2017</u>		
	HK\$	%	HK\$	%	
Non-current assets					
Property, plant and equipment	63,000	0.1%	62,000	0.1%	
Current assets					
Other debtors and prepaid expenses	98,361	0.1%	136,018	0.2%	
Investment in securities	4,627,800	4.3%	4,548,000	7.4%	
Cash and bank balances	123,885,960	114.1%	72,620,311	118.5%	
Bank time deposits	128,612,121	118.4%	77,304,329	126.2%	
Current liabilities					
Other creditors and accruals	16,083,035	14.8%	9,875,513	16.1%	
Receipts in advance	3,984,995	3.7%	6,216,205	10.1%	
	20,068,030	18.5%	16,091,718	26.3%	
Net current assets	108,544,091	99.9%	61,212,611	99.9%	
Net assets	108,607,091	100.0%	61,274,611	100.0%	



3. Financial statements analytics

c) Common-Size Statements

- Examples:

Common size income statement					
	<u>2018</u>		<u>2017</u>		
	HK\$	%	HK\$	%	
Income					
Government grants and subventions	588,158,472	85.0%	519,013,349	82.9%	
Donations and sponsorships	101,585,352	14.7%	105,545,155	16.9%	
Interest income	2,460,465	0.4%	1,639,554	0.3%	
	<u>692,204,289</u>	100.0%	<u>626,198,058</u>	100.0%	
Expenses					
Programme expense	13,429,527	1.9%	15,858,317	2.5%	
Staff costs	479,754,824	69.3%	488,977,355	78.1%	
Administrative expenses	158,489,272	22.9%	142,143,047	22.7%	
	<u>651,673,623</u>	94.1%	<u>646,978,719</u>	103.3%	
Surplus/(deficit) for the year	<u>40,530,666</u>	5.9%	<u>(20,780,661)</u>	-3.3%	

3. Financial statements analytics

d) Ratio analysis – common ratios

Financial analysis	Formula	Usage
Donor dependency ratio (捐贈者依賴比率)	Total donor income and sponsorship / Total income * 100%	Indication of how your organization is depending on donor and external aids for Sustainability
Income utilization ratio (收益利用率)	Total expenditure / Total income * 100%	Indication of how effective the organization is utilizing the grants and sponsorship
Administrative cost ratio (行政成本比率)	Total administrative costs / Total costs * 100%	Indication of the organization's administrative costs in relations to the total expenditures
Current ratio (流動比率)	Current assets / Current liabilities	Indication of whether the organization can pay off its debts within 12 months

3. Financial statements analytics

e) Identifying red flags

	Index	Red flag signal	Risk / Impact
Financial analysis	Variance between Budget and Actual	Permanent & Negative Variance	The larger value of the variance, more money should be deployed for the balance
	Current year to previous year ratio (YoY)	Too low or too high in %	$(\text{Current year item} / \text{previous year item}) * 100$
Cash flow analysis	Balance of cash flows	Negative value	The negative amount means the organization may not have enough cash to sustains the daily Operations

3. Financial statements analytics

e) Identifying red flags

	Index	Red flag signal	Risk / Impact
Ratio Analysis	Donor dependency ratio (捐贈者依賴比率)	High %	The higher % indicates the high dependence on one donor / external aids for sustainability. If the donor /aid no longer exists, charity will be harmed heavily.
	Income utilization ratio (收益利用率)	Low %	The lower % indicates that the organization utilizes the grants and sponsorship ineffectively.
	Administrative cost ratio (行政成本比率)	High %	The higher % indicates that the organization's administrative costs weights heavier among total Costs.
	Current ratio (流動比率)	Low value	The lower value indicates the lower ability for the organization to pay off its debts within 12 months.

3. Financial statements analytics

f) Further insights

- Balanced and recurring funding sources are important.
- Have service fees be adjusted to appropriate levels in view of demand, supply and inflation?
- Generating new sources and growing existing sources of revenue and effective cost management measures are keys to sustainable growth.
- Stakeholders pay extra attention to surplus/deficit level for an NGO and each of the presented accumulated funds in view of the unique non-profit-making motive.
- Surpluses or profits should be expected to fund future growth, deficit-making service units or funds, social enterprises operating on a self-financed basis and also for liquidity purpose.



3. Financial statements analytics

f) Further insights

- Has the NGO sacrificed/overlooked the financial results/implications when overly focused on operational results?
- Use and separate presentation of designated funds/reserves can provide additional information in better segregation.
- Transparency in financial reporting including effective communication of reserve policies is imperative.
- Are there sufficient investigations and follow-ups after financial statement analysis?
- Has the financial and non-financial information in the financial statements met objectives of the agencies and stakeholders?
- Do financial forecasts for the projects, service units and the reporting entity as a whole support financial feasibility and the going concern assumption?



4. Understanding auditors' reports (核數師報告)

4. Understanding auditors' reports

a) Requirements

- The auditor shall form **an opinion** on **whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.** (HKSA 700.10)
- In order to form that opinion, the auditor shall **conclude** as to whether the auditor has obtained **reasonable assurance** (合理保證) about whether the financial statements **as a whole are free from material misstatement** (不存在任何重大錯誤陳述), whether due **to fraud or error** (欺詐或錯誤). That conclusion shall take into account:
 - a) The auditor's conclusion, in accordance with HKSA 330, whether **sufficient appropriate audit evidence** (充足和適當的審計憑證) has been obtained;
 - b) The auditor's conclusion, in accordance with HKSA 450, **whether uncorrected misstatements are material, individually or in aggregate** (不存在重大失實陳述); and
 - c) The evaluations required by paragraphs 12- 15 (HKSA 700.11)



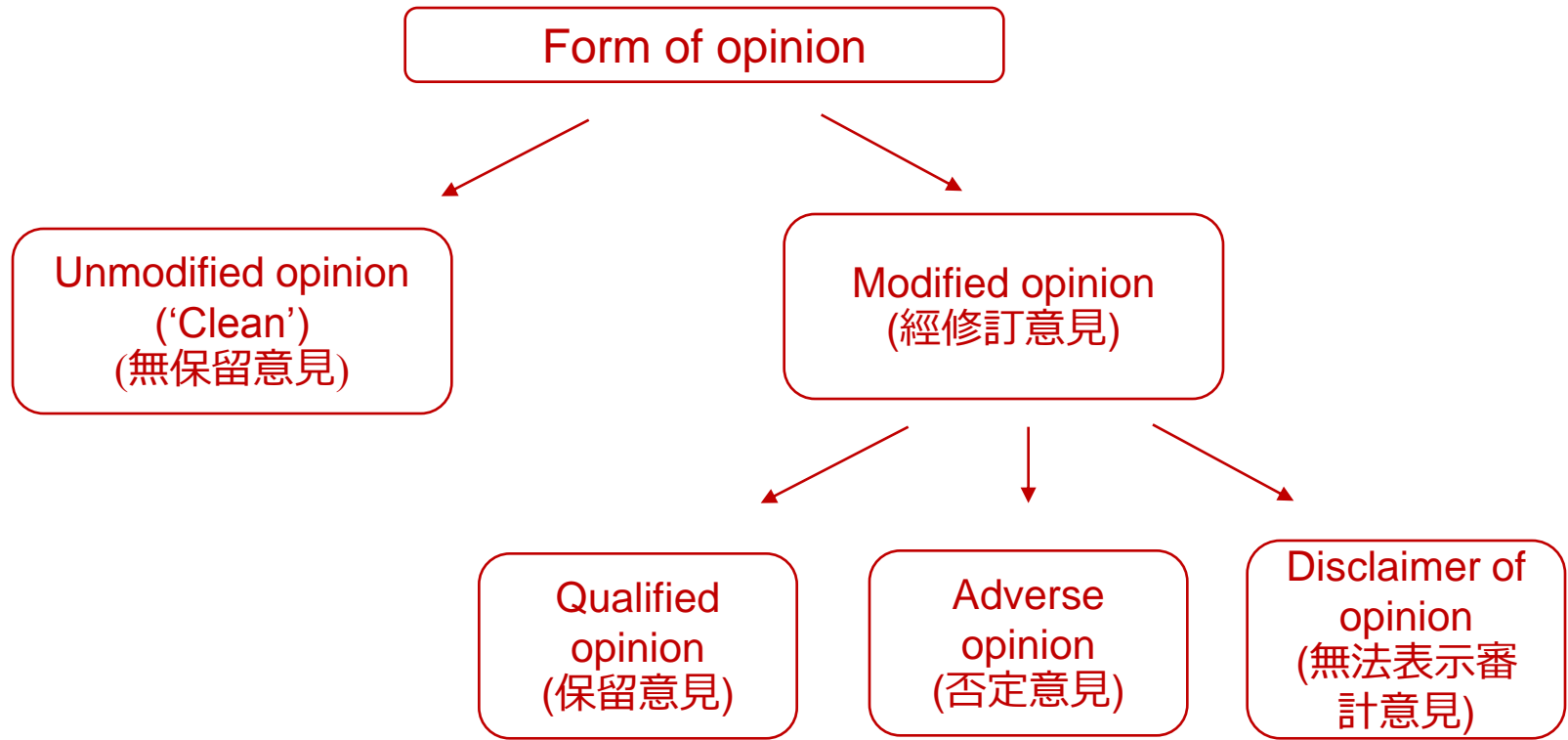
4. Understanding auditors' reports

a) Requirements - Contents

- Title
- Addressee
- Auditor's opinion
- Basis for opinion
- Other information
- Responsibilities of directors and those charged with governance for the financial statements
- Auditor's responsibilities for the audit of the financial statements
- Signature of the auditor
- Auditor's address
- Date of the auditor's report



4. Understanding auditors' reports



4. Understanding auditors' reports

b) Form of opinion

Qualified
opinion
(無保留意見)

Modified
opinion
(經修訂意見)

- The auditor shall express an **unmodified opinion** when the auditor **concludes** that the financial statements are prepared, **in all material respects, in accordance with the applicable financial reporting framework.** (HKSA 700.16)

- The auditor shall **modify the opinion** in the auditor's report when:
 - a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are **not free from material misstatement** (存在重大失實陳述); or
 - b) The auditor is **unable to obtain sufficient appropriate audit evidence** (無法獲得充足和適當的審計憑證) to conclude that the financial statements as a whole are free from material misstatement. (HKSA 705.6)

4. Understanding auditors' reports

b) Form of opinion

Qualified
opinion
(保留意見)

- The auditor shall express a **qualified opinion** when:
 - a) The auditor, having obtained sufficient appropriate audit evidence, concludes that **misstatements, individually or in the aggregate**, are **material**, but **not pervasive**, to the financial statements (此失實陳述屬**重大**但對財務報表並**無全面性影響**); or
 - b) The auditor **is unable to obtain sufficient appropriate audit evidence** on which to base the opinion, but the auditor concludes that **the possible effects on the financial statements of undetected misstatements**, if any, **could be material but not pervasive**. (HKSA 705.7)

4. Understanding auditors' reports

b) Form of opinion

Adverse
opinion
(否定意見)

- The auditor shall express an **adverse opinion** when the auditor, having obtained sufficient appropriate audit evidence, **concludes that misstatements, individually or in the aggregate**, are both **material** and **pervasive** to the financial statements (此失實陳述屬**重大**並對財務報表**具有全面性影響**). (HKSA 705.8)

Disclaimer
of opinion
(無法表示審
計意見)

- The auditor shall **disclaim an opinion** when the auditor is **unable to obtain sufficient appropriate audit evidence** on which to base the opinion, and the auditor concludes that the **possible effects** on the financial statements of **undetected misstatements**, if any, could be **both material and pervasive** (未能獲得充足和適當的審計憑證的可能影響屬**重大**, 並對財務報表**具有全面性影響**). (HKSA 705.9)

4. Understanding auditors' reports

b) Form of opinion

- Summary of modified opinion

<i>Nature of Matter Giving Rise to the Modification</i>	<i>Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements</i>	
	<i>Material but Not Pervasive</i>	<i>Material and Pervasive</i>
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Thank You!



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