

**PRACTICE NOTE  
851  
REVIEW OF THE ANNUAL FINANCIAL REPORTS  
OF NON-GOVERNMENTAL ORGANISATIONS**

*(Issued April 2001; revised September 2004 (name change))*

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

*They are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in Statements of Auditing Standards (SASs), even though they may be developed without the full process of consultation and exposure used for SASs. Auditors should be prepared to explain departures when called upon to do so.*

### **Introduction**

1. The purpose of this Practice Note (PN) is to provide guidance on the scope, conduct and reporting requirements in connection with a review of the Annual Financial Reports (AFRs) of Non-governmental Organisations (NGOs) pursuant to the requirements of the Lump Sum Grant Manual published by the Social Welfare Department of the Government of the HKSAR (SWD). This PN has been prepared in consultation with the SWD, and it has been agreed that the scope of work and reporting by auditors of NGOs under this PN would meet the requirements of a review of the AFRs of NGOs under the Lump Sum Grant Manual.
2. As explained in SAS 010 "The scope and authority of auditing pronouncements", as well as the audit of financial statements, auditors may be required to provide other audits and related services involving other financial information or non-financial information. Accordingly, references to auditors in this PN are not intended to imply that an audit is being or has been undertaken or that an audit opinion is expressed.

### **Lump Sum Grant**

3. With a view to improving the social welfare subvention system, the SWD has introduced a new funding system which takes the form of Lump Sum Grant (LSG) to replace mainly the Model System, Modified Standard Cost System, Lump Sum Grant Mode and Unit Rate Subsidy.
4. A NGO receives LSG in respect of its existing service units and newly allocated service units. LSG consists of the total of salaries, salary-related allowances, provident fund, other charges and recognised fee income.

### **Lump Sum Grant Manual**

5. The LSG Manual provides a self-contained and necessary reference for NGOs to operate under the new funding system, with a view to enhancing accountability, efficiency and cost-effectiveness in the use of public funds for the provision of welfare services.
6. Before embarking on a review of the AFRs, auditors would need to familiarise themselves with the provisions of the LSG Manual.
7. The purpose of the LSG Manual is to set out:
  - a. the structure of LSG, the arrangements for Tide-over Grant (TOG) and Provident Fund (PF) provision and other related matters;
  - b. the financial management of NGOs under LSG;
  - c. the respective roles and responsibilities and accountability of the SWD and NGOs for the use of public funds; and
  - d. guidance on best management practices and processes.

8. The purpose of TOG and actual PF payment is to enable NGOs to honour their contractual commitments in terms of salary increment and PF benefits to their Existing Staff as defined in the LSG Manual.
9. The LSG Manual provides the basic requirements in respect of accounting, financial reporting and internal control, compliance of which by NGOs is a pre-requisite for NGOs receiving LSG and is necessary to support sound financial management. A summary of the relevant requirements as extracted from the LSG Manual is set out in paragraphs 10 to 15 below.

**Accounting**

10. NGOs must ensure that proper books of account and other accounting records are kept for all transactions, separately identified into Funding and Services Agreement (FSA) activities and support services (including central administration and supervisory support), and non-FSA activities.
11. NGOs are required to keep separate Operating Income and Expenditure Account for each subvented service unit. NGOs are recommended to follow the Chart of Accounts set out in an Appendix to the LSG Manual in maintaining accounting records.

**Financial reporting**

12. NGOs must prepare the AFR in respect of all their FSA activities and support services funded by LSG, other social welfare subventions and other income. The AFR must:
  - a. derive its content from and be reconcilable with the Operating Income and Expenditure Accounts of all the subvented service units under FSAs;
  - b. show at agency level, in respect of PF subvention received and PF expenditure, the split between Existing Staff and 6.8% posts as defined in the LSG Manual; and
  - c. be an integral part of the NGOs' overall Annual Report.

A proforma AFR is provided in an Appendix to the LSG Manual.

13. NGOs must commission an independent review of the AFR to be carried out by their external auditors. Such a review should be performed in accordance with this PN.
14. NGOs are required to submit to the SWD not later than 31 July following the end of the financial year, i.e. 31 March:
  - a. the AFR together with a review report thereon issued by their external auditors; and
  - b. the audited financial statements of the NGO together with the auditors' management letter.

**Internal control**

15. Internal control is fundamental to sound and prudent financial management. NGOs should always ensure that adequate internal controls are in place having regard to the nature and size of their organisation and the services provided. Advice on internal control procedures in respect of important financial activities has been provided by the SWD as part of the Subvention Inspection process and is set out in an Appendix to the LSG Manual.

**Objective of review**

16. The objective of a review of the AFR is for the auditors to report whether:
  - a. in the auditors' opinion the AFR has been properly prepared from the books and records of the NGO; and
  - b. any matter has come to the auditors' attention during the course of their review, which causes them to believe that the NGO has not:
    - i. properly accounted for the receipt of LSG, PF, TOG and other social welfare subventions and expenditures in respect of FSA activities and support services;

- ii. kept separate Operating Income and Expenditure Account for each subvented service unit as required by the LSG Manual, i.e. all those units under FSAs which are funded by LSG, other social welfare subventions and other income;
- iii. prepared the AFR in accordance with the format and requirements set out in the LSG Manual; and
- iv. employed the staff quoted in the TOG and PF arrangements during the report period.

### **General principles of review engagement**

- 17. Auditors would need to comply with the Statements of Professional Ethics issued by the HKICPA. Ethical principles governing auditors' professional responsibilities are:
  - a. independence;
  - b. integrity;
  - c. objectivity;
  - d. professional competence and due care;
  - e. confidentiality;
  - f. professional behaviour; and
  - g. technical standards.
- 18. Auditors would conduct a review of the AFR in accordance with this PN.
- 19. Auditors would plan and perform the review of the AFR with an attitude of professional scepticism recognising that circumstances may exist which cause the AFR to be materially misstated.
- 20. For the purpose of expressing conclusions in the review report on the AFR, auditors would obtain sufficient appropriate evidence, primarily through enquiries and analytical procedures and with reference to the audit procedures performed in the audit of the financial statements of the NGO for the same period, to be able to draw conclusions.

### **Review procedures and evidence**

#### **Terms of engagement**

- 21. Auditors and the NGO would agree on the terms of the engagement. The agreed terms would be recorded in an engagement letter or other suitable form such as a contract. Standards and guidance on engagement letters are set out in SAS 140 "Engagement letters".
- 22. An engagement letter will be of assistance in planning the review work. It is in the interests of both the auditors and NGO that auditors send an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditors' acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditors' responsibilities and the form of reports to be issued.
- 23. Matters that would be included in the engagement letter include:
  - a. the objective of the review;
  - b. management's responsibility for the preparation of the AFR as required by the LSG Manual;
  - c. the scope of the review, including reference to this PN;
  - d. unrestricted access to whatever records, documentation and other information requested in connection with the review;
  - e. a sample or a description of the form of the report expected to be rendered;
  - f. the fact that the review cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist; and

- g. a statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasise this point and to avoid confusion, auditors may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of the AFR is given in Appendix I to this PN.

### **Planning**

- 24. Auditors would plan the work so that an effective review will be performed.
- 25. In planning a review of the AFR, auditors would make use of the knowledge of the business obtained during the course of the audit of the financial statements of NGO, including consideration of NGO's organisation, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.
- 26. Auditors need to possess an understanding of such matters and other matters relevant to the AFR, for example, a knowledge of NGO's services provided, to be able to make relevant enquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

### **Documentation**

- 27. Auditors would document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with this PN.

### **Procedures and evidence**

- 28. Auditors would apply judgement in determining the specific nature, timing and extent of review procedures. Auditors will consider matters including:
  - a. any knowledge acquired by carrying out audits of the financial statements for the current and prior periods, and reviews of the AFRs for prior periods;
  - b. auditors' knowledge of the services and activities including knowledge of the accounting principles and practices of the sector in which the NGO operates;
  - c. the NGO's accounting systems;
  - d. the extent to which a particular item is affected by management judgement; and
  - e. the materiality of transactions and account balances.
- 29. Auditors would apply the same materiality considerations as would be applied if an audit opinion on the AFR were being given. Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgement as to what is material is made by reference to the information on which auditors are reporting and the needs of those relying on that information, not to the level of assurance provided.
- 30. Procedures for the review of the AFR will ordinarily include:
  - a. enquiries concerning NGO's procedures for recording, classifying and summarizing transactions, accumulating information for disclosure in the AFR and preparing the AFR in accordance with the format and requirements set out in the LSG Manual;
  - b. enquiries concerning all material assertions in the AFR;
  - c. analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
    - i. comparison of the AFR with AFRs for prior periods;
    - ii. comparison of the AFR with anticipated results and financial position;
    - iii. study of the relationships of the elements of the AFR that would be expected to conform to a predictable pattern based on NGO's experience or industry norm.

In applying these procedures, auditors would consider the types of matters that required accounting adjustments in prior periods;

- d. enquiries concerning the staff movements in both the categories of Existing Staff and 6.8% posts as defined in the LSG Manual, and inspection of the payroll records to assess the responses and other information obtained;
  - e. enquiries concerning actions taken at meetings of the Management Board and other meetings, and correspondence between the SWD and NGO that may affect the AFR and LSG;
  - f. reading the AFR to consider, on the basis of information coming to the auditors' attention, whether the AFR appears to have been prepared in accordance with the format and requirements set out in the LSG Manual; and
  - g. enquiries of persons having responsibility for financial and accounting matters concerning, for example:
    - i. whether all transactions have been recorded;
    - ii. whether the AFR has been prepared in accordance with the format and requirements set out in the LSG Manual;
    - iii. changes in NGO's activities and the basis of preparation of the AFR;
    - iv. matters as to which questions have arisen in the course of applying the foregoing procedures.
31. Appendix 2 to SAS 700 "Engagements to review interim financial reports" provides an illustrative list of procedures which are often used in a review engagement. The list is not exhaustive, nor is it intended that all the procedures suggested apply to every review engagement. Auditors would make reference to this list in the preparation of their review programme.
32. If auditors have reason to believe that the information subject to review may be materially misstated, they would carry out additional or more extensive procedures as are necessary.

### **Management representations**

33. Guidance on management representations is set out in SAS 440 "Representations by management".
34. Auditors are encouraged to obtain confirmation of appropriate representations on matters material to the AFR when those representations are necessary to obtaining sufficient appropriate evidence. In addition the following representations would need to be obtained from management:
- a. the AFR has been properly prepared from the books and records of NGO; and
  - b. NGO has:
    - i. properly accounted for the receipt of LSG, PF, TOG and other social welfare subventions and expenditure in respect of FSA activities and support services;
    - ii. kept separate Operating Income and Expenditure Account for each subvented service unit as required by the LSG Manual, i.e. all those units under FSAs which are funded by LSG, other social welfare subventions and other income;
    - iii. prepared the AFR in accordance with the format and requirements set out in the LSG Manual; and
    - iv. employed the staff quoted in the TOG and PF arrangements during the report period.

### **Conclusions and reporting**

35. An example of the review report on the AFR is given in Appendix II to this PN.

**Appendix I**

**EXAMPLE ENGAGEMENT LETTER FOR THE  
REVIEW OF THE ANNUAL FINANCIAL REPORT**

The Management Board  
XYZ Charity ("the Charity")

[Date]

Dear Sirs

**REVIEW OF THE ANNUAL FINANCIAL REPORT**

This letter is to confirm our understanding of the terms and objective of our engagement to review the Charity's Annual Financial Report (AFR) and the nature and limitations of such a review.

**Objective of our review**

The objective of our review is to report to you whether:

- a. in our opinion the AFR has been properly prepared from the books and records of the Charity; and
- b. any matter has come to our attention during the course of our review, which causes us to believe that the Charity has not:
  - i. properly accounted for the receipt of Lump Sum Grant (LSG), Provident Fund, Tide-over Grant and other social welfare subventions and expenditure in respect of Funding and Services Agreement (FSA) activities and support services;
  - ii. kept separate Operating Income and Expenditure Account for each subvented service unit as required by the LSG Manual published by the Social Welfare Department of the Government of the HKSAR (SWD), i.e. all those units under FSAs which are funded by LSG, other social welfare subventions and other income;
  - iii. prepared the AFR in accordance with the format and requirements set out in the LSG Manual; and
  - iv. employed the staff quoted in the Tide-over Grant and Provident Fund arrangements during the report period.

**Responsibilities of management**

As management of the Charity, you are responsible for ensuring that the Charity maintains appropriate accounting records in accordance with the requirements of the LSG Manual. You are also responsible for making available to us, as and when required, all of the Charity's accounting records and all other relevant records and related information.

**Scope and limitations of our review**

Our review will be conducted in accordance with Practice Note 851 "Review of the Annual Financial Reports of Non-governmental Organisations" issued by the Hong Kong Institute of Certified Public Accountants. We shall expect to obtain appropriate evidence as we consider sufficient to enable us to draw reasonable conclusions on the AFR.

Our report is solely for your information and for submission to the SWD. We will not perform an audit of the AFR and, accordingly, will not express an audit opinion on the AFR. We advise that this review engagement will not satisfy any statutory or third party requirements for an audit. Accordingly, we expect to report on the AFR as follows:

(see Appendix II to this PN)

The responsibility for safeguarding the assets of the Charity and for the prevention and detection of fraud, errors and non-compliance with law or regulations rests with yourselves. Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we shall inform you of any material matters that come to our attention.

**Representations by management**

As part of our review procedures, we may request written confirmation of oral representations which we have received during the course of the review on matters having a material effect on the AFR.

**Access to information and documents**

In order to carry out our review effectively and efficiently, we will require access to all relevant records and documents of the Charity.

**Fees**

Our fees are computed on the basis of the time spent on your affairs by the partners and our staff, and on the levels of skill and responsibility involved plus out-of-pocket expenses. Fees will be due and payable on presentation.

**Agreement of terms**

Once it has been agreed, this letter will remain effective, from one review appointment to another, until it is replaced. The terms of this letter shall constitute the entire terms of the agreement between the Charity and [name of CPA (practising) firm] in respect of the review of the AFR. No variation to the terms hereof shall be effective or binding on either party unless they are agreed to in writing by both the Charity and [name of CPA (practising) firm].

We should be grateful if you would confirm in writing your agreement to these terms, by signing and returning the enclosed copy of this letter, or let us know if they are not in accordance with your understanding of our terms of engagement.

Yours faithfully,

.....  
ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]

\_\_\_\_\_

We agree to the terms of this letter.

.....  
Signed, for and on behalf of XYZ Charity

.....  
Date

.....  
Position



**Appendix II**

**EXAMPLE REVIEW REPORT ON THE ANNUAL FINANCIAL REPORT  
- UNQUALIFIED CONCLUSION**

**Review Report to the Management Board of XYZ Charity ("the Charity")**

We have audited the financial statements of the Charity for the year ended [31/3/2001] and have issued [an unqualified/a qualified] auditors' report thereon dated [XX/YY/ZZZZ].

We conducted our review of the attached Annual Financial Report on pages \_\_\_\_ to \_\_\_\_ of the Charity for the year ended [31/3/2001] in accordance with Practice Note 851 "Review of the Annual Financial Reports of Non-governmental Organisations" issued by the Hong Kong Institute of Certified Public Accountants. The review includes considering the procedures and records relevant to the preparation of the Annual Financial Report and performing procedures to satisfy ourselves that the Annual Financial Report has been properly prepared from the books and records of the Charity, on which the above audited financial statements of the Charity are based.

**Review conclusions**

On the basis of the results of our review and having regard to the audit procedures performed by us in relation to the audit of the financial statements of the Charity for the year ended [31/3/2001]:

- a. in our opinion the Annual Financial Report has been properly prepared from the books and records of the Charity; and
- b. no matters have come to our attention during the course of our review, which cause us to believe that the Charity has not:
  - i. properly accounted for the receipt of Lump Sum Grant, Provident Fund, Tide-over Grant and other social welfare subventions and expenditure in respect of Funding and Services Agreement activities and support services;
  - ii. kept separate Operating Income and Expenditure Account for each subvented service unit as required by the Lump Sum Grant Manual (LSG Manual) published by the Social Welfare Department of the Government of the HKSAR;
  - iii. prepared the Annual Financial Report in accordance with the format and requirements set out in the LSG Manual; and
  - iv. employed the staff quoted in the Tide-over Grant and Provident Fund arrangements during the year ended [31/3/2001].

This report is intended for filing with the Social Welfare Department of the Government of the HKSAR and should not be used for any other purpose.

ABC & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
Hong Kong  
Date