Proceedings No: D-20-1638P

IN THE MATTER OF

A Complaint made under section 34(1) of the Professional Accountants Ordinance (Cap. 50) (the "**PAO**")

BETWEEN

The Practice Review Committee of the Hong Kong Institute of Certified Public Accountants	COMPLAINANT
AND	
Mr. Wong Ho Yuen, Gary (F01794)	1st RESPONDENT
Mr. Chan Lap Chi (A18249)	2nd RESPONDENT

Before a Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants (the "**Disciplinary Committee**")

Members: Mr. Chiu Shun Ming (Chairman)
Mr. Fong Wai Kuk, Dennis
Mr. Lam Tsz Chung
Mr. Kwok Kai Bun
Mr. Lee Kwo Hang, Felix

ORDER AND REASONS FOR DECISION

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1. This is a complaint made by the Practice Review Committee of the Hong Kong Institute of Certified Public Accountants (the "**PRC**") as Complainant against Mr. Wong Ho Yuen, Gary and Mr. Chan Lap Chi, both practising certified public accountants (the "**Respondents**"). The PRC complains that the Respondents failed or neglected to observe, maintain or otherwise apply professional standards under section 34(1)(a)(vi) of the PAO.

2. The PRC brought the complaint against the Respondents by a letter to the Registrar of the Institute dated 12 May 2021.

THE PROCEEDINGS

3. On 6 October 2021, the parties made a joint application to the Disciplinary Committee to dispose of the proceedings summarily by adopting the Carecraft procedure. The parties submitted an agreed statement of facts (the "**Carecraft Statement**"), which also includes agreed proposed orders as to sanctions and costs.

4. The Carecraft procedure has its origins in the case of *Re Carecraft Construction Co Ltd* [1994] 1 WLR 172. It essentially limits the facts, by way of a statement of agreed facts, on which the Disciplinary Committee may decide whether the complaint referred to it has been proved and, if so, determine the sanction that ought to be imposed.

5. The Disciplinary Committee understands the Carecraft procedure has been invoked in disciplinary proceedings under the PAO.

6. The Disciplinary Committee agreed to the parties' joint application to dispense with the proceedings by adopting the Carecraft procedure, in light of the parties' submissions, the Disciplinary Committee's discretion to dispense with or vary any procedural requirements as and when appropriate under rule 11 of the *Disciplinary Committee Proceedings Rules*, and the principle of procedural fairness under paragraph 2 of the *Guidelines for the Chairman and the Committee on Administering the Disciplinary Committee Proceedings Rules*.

7. The Disciplinary Committee further directed that the disciplinary proceedings be adjourned.

THE COMPLAINTS, AND SUPPORTING FACTS AND CIRCUMSTANCES

8. For want of clarity and in light of the parties' agreement (as stated in paragraph 6 of the Carecraft Statement), the Carecraft Statement is annexed to this order.

9. There is one complaint against each of the 1st Respondent and the 2nd Respondent. These complaints were set out in paragraph 4 of the Carecraft Statement.

10. The agreed facts of these complaints are set out from paragraphs 8 to 37 of the Carecraft Statement.

DISCUSSION AND DECISION

11. The complaints are all found proven on the basis of the admission made by the Respondents.

12. The only outstanding matter is the question of sanctions and costs which ought to be imposed upon the Respondents.

13. The parties' agreed mitigating factors and agreed proposed orders were set out from paragraphs 38 to 40 of the Carecraft Statement.

14. In considering the proper order to be made in this case, the Disciplinary Committee has had regard to all the aforesaid matters, including the particulars in support of the complaints, the agreed mitigating factors, and the conduct of the Complainant and the Respondents throughout the proceedings.

15. In terms of costs, the Disciplinary Committee considers that the sum incurred by the Complainant and the Clerk was reasonable and ought to be borne by the Respondents.

SANCTIONS AND COSTS

16. The Disciplinary Committee orders that:-

(1) the Respondents be reprimanded under section 35(1)(b) of the PAO;

(2) the 1st Respondent pay a penalty of HK$100,000.00 under section 35(1)(c) of the PAO;

(3) the 2nd Respondent pay a penalty of HK$50,000.00 under section 35(1)(c) of the PAO; and

(4) the Respondents pay jointly and severally the total costs of the Complainant in the sum of HK$100,000 and of the Clerk in the sum of HK$4,394 under section 35(1)(iii) of the PAO.

Dated the 22nd day of November 2021.

Mr. Chiu Shun Ming
Chairman
Disciplinary Panel A

Mr. Fong Wai Kuk, Dennis
Member
Disciplinary Panel A

Mr. Kwok Kai Bun
Member
Disciplinary Panel B

Mr. Lam Tsz Chung
Member
Disciplinary Panel A

Mr. Lee Kwo Hang, Felix
Member
Disciplinary Panel B

Proceedings No.: D-20-1638P

IN THE MATTER OF

A Complaint made under section 34(1) of the Professional Accountants Ordinance

BETWEEN

The Practice Review Committee of the Hong Kong Institute of Certified Public Accountants	Complainant
AND	
Wong Ho Yuen, Gary (F01794)	1st Respondent
Chan Lap Chi (A18249)	2nd Respondent

STATEMENT OF AGREED FACTS FOR CARECRAFT PROCEDURE IN RESPECT OF THE 1ST AND 2ND RESPONDENTS

PART 1- INTRODUCTION

1. A complaint dated 12 May 2021 was submitted to the Council of the Hong Kong Institute of Certified Public Accountants (the "**Institute**") in relation to the 1st Respondent and 2nd Respondent (collectively "**Respondents**"). The Council of the Institute resolved to refer the complaint to the Disciplinary Panels pursuant to section 34(1) of the Professional Accountants Ordinance (Cap. 50) ("**PAO**").

2. Subject to the approval of the Disciplinary Committee, the Complainant and the Respondents agree to dispose of these proceedings by way of the Carecraft procedure (the "**Carecraft Procedure**") sanctioned by the High Court in England and Wales in the case of Re Carecraft Construction Co Ltd [1994] 1 WLR 172 and clarified by the English Court of Appeal in Secretary of State for Trade and Industry v Rogers [1996] 1 WLR 1569. The Carecraft Procedure was adopted in Hong Kong in a number of cases in respect of proceedings under section 214 of the Securities and Futures Ordinance (Cap. 571), section 168H of the former Companies Ordinance (Cap. 32), by the Competition Tribunal, and also by the Disciplinary Committee of the Institute.

3. This Statement of Agreed Facts ("**Statement**") is submitted by the parties for the purpose of setting out the factual basis upon which the Disciplinary Committee is invited to make the orders sought.

4. For the purpose of resolving these proceedings summarily, and by reference to the facts as set out in Part 2 of this Statement which the Respondents admit and accept, the Respondents admit the complaints against them as follows:

a. Section 34(1)(a)(vi) of the PAO applies to the 1st Respondent in that he failed or neglected to observe, maintain or otherwise apply professional standards in respect of the audit of a listed entity ("**Client C**") and its subsidiaries (collectively "**Group**") for the year ended 31 December 2018 ("**First Complaint**").

b. Section 34(1)(a)(vi) of the PAO applies to the 2nd Respondent for having failed or neglected to observe, maintain or otherwise apply a professional standard when carrying out an engagement quality control review in the audit of the Group for the year ended 31 December 2018 ("**Second Complaint**").

5. The facts set out in this Statement are not disputed between the Complainant and the Respondents on the basis that these proceedings will be dealt with by the Disciplinary Committee by way of the Carecraft Procedure. If the Disciplinary Committee for any reason is of the view that these proceedings shall not be dealt with by the Carecraft Procedure or that a full hearing is appropriate, no admission or concession by either the Complainant or the Respondents and none of the proposed orders referred to below shall be referred to or relied upon by any of the parties at any subsequent hearing without the prior written consent of the Complainant and the Respondents.

6. In the event that the Disciplinary Committee makes any order sought against the Respondents by reference to this Statement, the Complainant and the Respondents agree that this Statement be annexed to the Disciplinary Committee's decision and will jointly seek a direction to that effect.

7. Furthermore, without prejudice to all of the Complainant's rights, the Complainant specifically reserves the right to (a) disclose this Statement to third parties where it appears proper to do so in the public interest; and (b) refer to this Statement for purposes ancillary to, connected with and/or arising out of these proceedings.

PART 2— AGREED FACTS

A. Background

8. Confucius International CPA Limited (corporate practice no. M0648) (the "**Practice**") was subject to a full scope practice review which was concluded in April 2020.

9. The practice review team ("**Reviewer**") reviewed the Practice's audit of the financial statements of a listed entity Client C (or the "**Company**") and its subsidiaries for the year ended 31 December 2018 ("**2018 Financial Statements**").

10. The 1st Respondent was the engagement director and the 2nd Respondent was the engagement quality control reviewer ("**EQCR**").

11. Client C is a company listed on the Main Board of the Stock Exchange of Hong Kong Limited. The Group's principal activities included manufacturing and sales of slippers, sandals, casual footwear, and graphene-based products.

12. The 2018 Financial Statements were stated to have been prepared in accordance with International Financial Reporting Standards. The auditor's report of the 2018 Financial

Statements stated that the audit was conducted in accordance with Hong Kong Standards on Auditing ("**HKSA**").

13. The Practice expressed an unmodified opinion in its auditor's report on the 2018 Financial Statements dated 27 March 2019.

14. In reviewing the audit of the Group, the Reviewer found a number of deficiencies which indicated that the auditor failed to perform adequate audit work to obtain sufficient and appropriate audit evidence and prepare adequate documentation to support the audit opinion on the 2018 Financial Statements.

15. In view of the Reviewer's findings and the public interest element involved in Client C, the Practice Review Committee ("**PRC**") decided to raise a complaint against the Respondents.

B. In respect of the First Complaint

16. As at 31 December 2018, the Group had intangible assets with an aggregate value of RMB364,246,000, representing 63.8% of the Group's total assets. The intangible assets comprised (i) technology know-how of RMB288,000,000, (ii) O2O distribution vending system ("**O2O system**") of RMB48,440,000, and (iii) deferred development costs, which represented the costs for the patents of sterilizing chips used in air purifiers / conditioners, of RMB27,806,000. In 2018, the Group had recognized an impairment loss on technology know-how of RMB195 million. These assets are material to the 2018 Financial Statements.

17. The working papers of Client C and its subsidiaries show that the auditor failed to perform adequate audit procedures and prepare adequate documentation in respect of the following audit areas to support the audit conclusion on the valuations for the purpose of impairment assessment of intangible assets:

Basis of measuring recoverable amount in assessing impairment

18. The Company had performed impairment assessments of technology know-how and deferred development costs at the year-end date by comparing their respective carrying amounts with their recoverable amounts as at 31 December 2018. The 2018 Financial Statements stated that the recoverable amounts of the technology know-how and deferred development costs were determined by the Company's valuers based on value in use calculation ("**VIU**"). Under IAS 36, calculation of VIU should be done by discounting the future cash flows expected to be derived from the asset or cash-generating unit to its present value.

19. However, the valuation reports of technology know-how and deferred development costs stated that the valuers were engaged to determine the "fair value" of the technology know-how and the "market value" of patents of sterilizing chips as at 31 December 2018.

20. Given the inconsistent measurement bases apparently underlying the stated amounts of technology know-how and deferred development costs (i.e. "fair value" or "market value" used by the Company's valuers and VIU used by the management), the auditor should have performed additional procedures to follow up. There was no evidence that the auditor had identified and discussed with the valuers and management about the

inconsistency and performed procedures to assess the implications for the calculation of the recoverable amounts.

Basis of determining cash-generating unit ("CGU") in assessing impairment

21. In addition, the 2018 Financial Statements stated that the directors of the Company had determined the technology know-how and the O2O system as a CGU and that should form a basis for impairment assessment. However, the Company only performed an impairment assessment on the valuation of technology know-how and no assessment was performed on the valuation of O2O system at the year-end date. There was no evidence of the auditor challenging management the reasons for not assessing the value of CGU as a whole, especially when the performance of technology know-how relied on the O2O system.

22. Further, there was no evidence that the auditor had performed procedures to ascertain whether the CGU (or groups of CGUs) was properly determined and that all the relevant assets belong to the CGU (or groups of CGUs) had been identified and included in the CGU (or groups of CGUs) by the management.

Sales and cash flow forecasts used in assessing impairment of technology know-how

23. The working papers show that the auditor relied on the valuation done by the Company's valuer to support its audit conclusion on impairment of technology know-how. The valuation was determined based on a 7-year cash flow projection and an annual growth in sales at a rate ranged from a negative growth rate of 69% to a positive growth rate of 597%.

24. During the practice review, the auditor represented to the Reviewer that the forecast sales were based on a market research performed on the slipper market in Mainland China ("**Market Research**"). The results of the research indicated a positive growth in the slippers market and the management expected that the Company would capture a portion of the slipper market in Mainland China over the forecast period.

25. Apart from accepting the management's representations above, there was no evidence that the auditor had critically assessed whether the management's assumption of attaining the market share as expected in the slipper market was reasonable and supportable. Also, the working papers did not document any details of the Market Research and the auditor's assessment of its reliability, nor was there documentation of the auditor obtaining corroborative evidence to support the validity of management's expected capturing of the stated market share and the annual growth rates used in the Company valuer's cash flow projection.

26. Moreover, paragraph 33(b) of IAS 36 states that projections based on forecasts shall cover a maximum period of 5 years, unless a longer period can be justified. The projection period used by the Company's valuer in its valuation on technology know-how was 7 years. There was no evidence that the auditor had performed audit procedures to justify management and valuer's rationale of using 7 years rather than 5 years in the projections and that such a forecast period was in compliance with IAS 36.

Contributory assets underlying the technology know-how

27. According to the valuation report, the fair value of the technology know-how was determined based on the estimated earnings from four contributory assets (including working capital, fixed assets, assembled workforce and O2O system) identified by the Company's valuer. Such earnings were calculated based on a contributory asset charge ("**CAC**") for the use of the contributory assets. There was no evidence that the auditor had evaluated how the contributory assets were determined and whether the CACs assumed in the valuation were appropriate.

28. Further, as mentioned in paragraph 27 above, the performance of technology know-how depended on the O2O system and other assets. An impairment loss on technology know-how recognized in 2018 should have heightened the auditor's concern as to whether the contributory assets which supported the technology know-how were impaired. There was no evidence of audit work to assess the potential impact on the contributory assets as a result of the impairment of technology know-how.

29. There was also no evidence that, in accepting the above valuation, the auditor had performed adequate procedures to assess the relevance and reasonableness of the other key assumptions and data used in the valuation, including discount rate and forecasts of costs of sales and operating expenses.

Impairment assessment of deferred development costs

30. The working papers show that the auditor relied on the valuation done by the Company's valuer to support its audit conclusion on impairment of deferred development costs. The valuation was determined based on an assumption that working capital was the only contributory asset for the patents of sterilizing chips.

31. There was no evidence that the auditor had performed audit procedures to ascertain how the contributory asset was determined and whether the CAC assumed in the valuation was appropriate. In addition, there was no evidence of adequate audit procedures carried out to assess the relevance and reasonableness of the key assumptions and data used in the valuation, including discount rate and the forecast sales in which management assumed that the sales of air-purifiers / conditioners would be increased from one unit in 2018 to 7,000 units in 2019.

32. The 1st Respondent was responsible for the audit of the 2018 Financial Statements as the engagement director. As a result of the audit deficiencies identified above, he failed to:

    a. perform audit procedures with adequate professional skepticism in accordance with paragraph 15 of HKSA 200;
    b. sufficiently evaluate the appropriateness of the work performed by the Company's valuers and carry out adequate audit procedures to support the audit conclusion on the valuations for the purpose of impairment assessment of intangible assets at the year-end date, in accordance with paragraphs 6 and 8 of HKSA 500;
    c. perform adequate audit procedures to evaluate the accounting estimates and the measurement methods used in the valuations for the purpose of impairment assessment, in accordance with paragraphs 13, 15 and 18 of HKSA 540; and

d. prepare adequate documentation for the audit work performed in accordance with paragraph 8 of HKSA 230.

C. In respect of the Second Complaint

33. The impairment assessment of intangible assets was identified by the engagement team as a high risk audit area and a key audit matter in the 2018 audit. This audit area involved significant judgement and estimation.

34. The 2nd Respondent as EQCR was responsible for performing an adequate review of this audit area to ensure that the audit evidence obtained and procedures performed by the engagement team were sufficient and appropriate to support the audit conclusions.

35. The working papers show that the 2nd Respondent was satisfied with the audit procedures performed on significant financial statements areas, significant risks areas, and management estimates, and that a sufficient and appropriate record for the basis of audit report had been documented.

36. The above analysis show that the engagement team did not perform sufficient procedures to support the audit conclusion on the valuations for the purpose of impairment assessment of intangible assets. The 2nd Respondent failed to identify the insufficient work done by the engagement team. There was no documentation in the working papers to show how the 2nd Respondent had evaluated the significant matters and judgments made by the engagement team regarding impairment assessment of the intangible assets to support his conclusion that the audit procedures performed and documented by the engagement team were appropriate.

37. On the basis of the above findings, the 2nd Respondent failed to perform an adequate engagement quality control review and was thereby in breach of paragraph 20 of HKSA 220.

PART 3- AGREED MITIGATING FACTORS

38. The Complainant and the Respondents agree to the following mitigating factors:

a. There is no evidence that the Respondents gained any benefits from the breaches mentioned above;

b. There have not been any civil claims against the Practice in respect of the audit of the 2018 Financial Statements;

c. The 1st Respondent has one previous disciplinary record in December 2018 (D-16-1203F) in connection to a PIE audit engagement for the year ended 31 December 2010, to which he was reprimanded, ordered to pay a financial penalty of $50,000 and costs. However, it is agreed that the previous case involved the 1st Respondent's role as EQCR, which is different from the present case;

d. The 2nd Respondent has no previous disciplinary record; and

e. The Respondents have adopted a reasonable course of action to conclude these proceedings by way of the Carecraft Procedure, which saves the time and costs of the Complainant and the Disciplinary Committee.

PART 4- AGREED PROPOSED ORDERS

39. On the basis of the agreed facts set out in Part 2 above, the Complainant and the Respondents agree that the Disciplinary Committee should find the complaints against the Respondents (as set out in paragraphs 4(a) and (b) above) proved.

40. On the basis of the agreed facts set out in Part 2 above and taking into account the agreed mitigating factors in Part 3 above, the Complainant and the Respondents further agree that it would be appropriate for the Disciplinary Committee to make the following sanctions:

    a. The Respondents be reprimanded under section 35(1)(b) of the PAO;

    b. The 1st Respondent do pay a penalty of HK$100,000 under section 35(1)(c) of the PAO;

    c. The 2nd Respondent do pay a penalty of HK$50,000 under section 35(1)(c) of the PAO;

    d. The costs and expenses of the Complainant in the sum of HK$100,000 to be paid by the Respondents jointly and severally, under section 35(1)(iii) of the PAO; and

    e. The costs and expenses of the Disciplinary Committee, in the sum of HK$4,394, to be paid by the Respondents jointly and severally, under section 35(1)(iii) of the PAO.

Dated the 4th day of October 2021.