Proceedings No: D-15-1049P

IN THE MATTER OF

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

BETWEEN

The Practice Review Committee of the Hong Kong Institute of Certified Public Accountants — COMPLAINANT

AND

Cheung Yiu Hung (F00734) — RESPONDENT

Members: Mr. CHOW, Cheuk Yu, Alfred (Chairman)
Miss WOO, Lee Wah, Cecilia
Mr. WONG, Chun Bong, Alex
Mr. WONG, Sai Hung, Oscar
Mr. CHAN, Stephen

Date of hearing: 4 and 5 January 2017

Date of Order & Reasons for Decision: 1 June 2017

REASONS FOR DECISION & ORDERS

Section A - BACKGROUND

1. This is a complaint made by the Practice Review Committee of the Hong Kong Institute of Certified Public Accountants ("**Institute**") as Complainant against the Respondent, Mr. Cheung Yiu Hung, a certified public accountant (practising). Section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50) ("**PAO**") applied to the Respondent.

2. The Respondent is the sole proprietor of Y.H. Cheung & Company (firm no.: 0502) ("**Practice**"). He is responsible for the quality control system of the Practice.

3. The Practice was selected for a practice review in May 2013 ("**Initial Review**"). During this review, the Practice Review Committee ("**PRC**") conducted assessments on the system of quality control of the Practice and selected for review two completed audit engagements in respect of Client Y and Client S for the audit year ended 31 March 2012. Various deficiencies were identified in the findings of the PRC which are set out in the Report attached to the letter from the Institute to the Respondent dated 31 July 2013 ("**Initial Review Report**"). In its written response to such findings, the Practice gave explanations and set out remedial plans with time frame for implementation.

4. The PRC conducted a follow up practice review in May 2014 ("**2nd Review**"). The PRC noted that the Practice still failed to implement necessary improvements it had promised to do so. Also when reviewing the audit engagements working papers of Client S and Client Y both for the year ended 31 March 2013 ("**the 2013 Working Papers**"), the practice reviewer found the recurrence of the same or similar deficiencies identified in the Initial Review. The findings of PRC in the 2nd Review are set out in the report sent to the Respondent on 7 October 2014 ("**2nd Review Report**").

5. Following further correspondences, the present Complaint was commenced on 22 December 2015.

6. Various submissions with exhibits, appendices and working papers (collectively "**Submissions**") were submitted by the parties. Some of the contents of the Submissions are not relevant to the present Complaint or are only of peripheral relevance. The Committee has considered all the Submissions, although the Committee will not discuss every single point made in the Submissions.

Section B – COMPLAINTS

7. The Complainant made the following 5 complaints:

(a) First Complaint

Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he had failed or neglected to observe, maintain or otherwise apply a professional standard namely, Hong Kong Standard on Quality Control 1 "*Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*" (Revised July 2010) ("**HKSQC 1**") as the Practice had not implemented adequate quality control policies and

procedures in respect of monitoring, client acceptance and continuance, and engagement performance.

(b) Second Complaint

Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he had failed or neglected to observe, maintain or otherwise apply a professional standard namely, paragraph 6 of HKSA 500 in that he had failed to design and/or perform audit procedures that were appropriate for the purpose of obtaining sufficient appropriate audit evidence in relation to the audit of the financial statements of Client S for the year ended 31 March 2013.

(c) Third Complaint

Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he had failed or neglected to observe, maintain or otherwise apply a professional standard namely, paragraph 6 of HKSA 500 in that he had failed to design and/or perform audit procedures that were appropriate for the purpose of obtaining sufficient appropriate audit evidence in relation to the audit of the financial statements of Client Y for the year ended 31 March 2013.

(d) Fourth Complaint

Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he had failed or neglected to observe, maintain or otherwise apply a professional standard namely, paragraph 5 of HKSA 230 in that he had failed to adequately document the evidence obtained and procedures performed in relation to the audit of the financial statements of Client S for the year ended 31 March 2013.

(e) Fifth Complaint

Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he had failed or neglected to observe, maintain or otherwise apply a professional standard namely, paragraph 5 of HKSA 230 in that he had failed to adequately document the evidence obtained and procedures performed in relation to the audit of the financial statements of Client Y for the year ended 31 March 2013.

8. The Respondent has denied each of these complaints.

Section C – FIRST COMPLAINT

9. The Complainant states that the Practice for which Respondent is responsible fails in areas of (i) Monitoring, (ii) Client Acceptance and Continuance, and (iii) Engagement Performance.

(1) MONITORING

The Complaint

10. Paragraph 48 of HKSQC 1 provides as follows:

> *"48. The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The process shall:*
> *(a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner;*
> *(b) .....*
> *(c) ....."*

11. The Complainant states the following:

(a) The Practice failed to establish a monitoring process which include an ongoing consideration and evaluation of the Practice's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner, as required under paragraph 48 of HKSQC 1.

(b) In the Initial Review, it was found that the Respondent did not carry out a monitoring review. The PRC then issued a letter to the Practice requiring the Practice to submit a monitoring report prepared by an external monitor by 31 March 2014.

(c) In the 2nd Review, there was no evidence showing that the monitoring process was carried out during the period under review.

Respondent's Response

12. In the Initial Review Report, it was stated that no monitoring review had been carried out by the Practice. The Respondent did not seem to dispute this. In the Appendix to his letter dated 15 July 2013 in

response to the Initial Review Report, the Respondent stated that there was "*No monitoring review yet*" and that "*Monitoring review to be carried out at year end*".

13. The Respondent claimed that after the Initial Review, he did find an external reviewer. However, when he was told that the PRC would conduct a follow up review, he withheld engaging the external reviewer as he thought that the 2nd Review could serve the purpose of monitoring review.

14. The Respondent submitted that the relevant standard in HKSQC 1 did not require review to be carried out each year and that there was no specific time to do so. Also there was no specific requirement for external reviewer to do the review. Hence the absence of monitoring review in the year of practice review was allowable.

15. The Respondent submitted a copy of Quality Control Manual of the Practice with date "*April 2014*". Paragraph 6 of that Manual had the heading "*Monitoring*".

Discussion

16. In the light of the evidence and the Respondent's admission, it is evident that no monitoring review was carried out during the period between the two reviews by the PRC.

17. While there was a new paragraph "*Monitoring*" in the revised Quality Control Manual of the Respondent in 2014, the content of that paragraph did not make provision for an ongoing consideration and evaluation of the Practice's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner.

18. The Respondent has not pointed to any material showing that the Practice had conducted monitoring review on at least one completed engagement by 2014 and the Practice had established a monitoring process which satisfied paragraph 48 of HKSQC 1. The Respondent's misconception that the Practice Review could be a substitute for monitoring review demonstrated the Respondent's lack of understanding of the requirements for a proper monitoring review.

Conclusion

19. Having considered all relevant materials, the Committee finds that the Practice had not complied with the requirements in paragraph 48 of HKSQC 1 and the Respondent is responsible for such failure.

(2) CLIENT ACCEPTANCE AND CONTINUANCE

The Complaint

20. Paragraph 26 of HKSQC 1 provides as follows:

> *"26. The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:*
> *(a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: Para. A18, A23)*
> *(b) Can comply with relevant ethical requirements; and*
> *(c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity."*

21. The Complainant states that the Practice failed to comply with the said paragraph 26 of HKSQC 1 because the client acceptance forms completed by the Practice provided:

(a) No documentation of whether the Practice had considered its compliance with independence requirements; and

(b) No date of approval showing whether the client acceptance process was performed before accepting the engagement with a new or existing client.

22. The Complainant states that such non-compliance was identified in the Initial Review and the Respondent undertook to rectify the same. However, in the 2nd Review, there were still no adequate policies and procedures having been established.

Respondent's Response

23. In the response to the Initial Review Report, the Respondent admitted that detailed decision process on continuance with client decision had not been written down to indicate that all factors had been assessed and the Respondent promised that documentation of the decision for accepting or continuance of the engagement would be supplied in future.

24. The Respondent contends that the words "independence" and "date" do not appear in paragraph 26 of HKSQC1. He also contends that the

works he had done implied that these areas had been considered and documented.

Discussion

25. In the 2nd Review, the practice reviewer found that the client acceptance procedures did not include consideration of compliance with ethical requirements and that there was no date of approval in the client acceptance form. This seems to relate to the two client's acceptance form as shown in Hearing Bundle A6 and A7 ("**the 2 CA Forms**").

26. The Respondent seeks to rely on the following written remarks in the 2 CA Forms:

> "*The client is a small church and we do not feel any threat existed.*"
> "*The client is a small company and we do not feel any threat existed.*"

These are by themselves unclear in their meaning and do not bear any direct reference to independence. The 2 CA Forms do not contain any statement relating to consideration of "independence".

27. "Independence" is clearly one of the ethical requirements as set out in paragraphs 21 to 24 of HKSQC 1 and the reference in paragraph 26 of HKSQC 1 to relevant ethical requirements must include "independence".

28. There is no date shown on the 2 CA Forms. The Respondent has not provided any evidence that the forms were completed before the acceptance of the clients.

29. The policies and procedures required under paragraph 26 of HKSQC1 must be clear and effective. The Committee was not referred by the Respondent to documentary evidence showing that such established policies and procedures existed. Rather the assertion by the Respondent that the Practice simply knew the clients for a long time and so knew them very well with no reference to any policies or procedures indicates that, even if the Respondent had made any assessment of the requirements under paragraph 26 HKSQC 1, the Respondent did not make the assessment based on some established policies or procedures.

Conclusion

30. In view of the aforesaid, the Committee finds that the Respondent

failed to establish policies and procedures for the acceptance and continuance of client relationship and engagements that meet the requirements of paragraph 26 of HKSQC 1.

(3) ENGAGEMENT PERFORMANCE

The Complaint

31. Paragraph 32 of HKSQC 1 provides as follows:

> "*32. The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances .....*"

32. The Complainant states the following:

(a) In the Initial Review, the practice reviewer noted various deficiencies in the audit work of the Practice. In response to the Initial Review Report, the Respondent noted such deficiencies and provided improvement plans to address the deficiencies.

(b) However, in the 2nd Review, the practice reviewer found that there were various recurring deficiencies relating to audit evidence, documentation, internal control evaluation and fraud risk assessment. Such deficiencies are set out in the Second to Fifth Complaints below.

(c) Because of such deficiencies, the Practice was considered to have not complied with HKSQC 1 as it had failed to establish policies and procedures effective to ensure that audit engagements performed are in accordance with relevant auditing standards.

Discussion and Conclusion

33. For the reasons to be set out in later part of this Decision in relation to Second to Fifth Complaints below, the Committee finds that the repeated deficiencies indicates that there were non-compliance in the following areas:

(a) Evaluation of design and implementation of key internal controls as required by HKSA 315.

(b) Assessment of fraud risk as required by HKSA 240; and

(c) Documentation of the basis for establishing appropriate materiality and sampling in accordance with HKSA 320 and HKSA 530 respectively.

34. The Respondent has not provided any evidence showing that the Practice has established policies and procedures that satisfy paragraph 32 of HKSQC 1.

(4) CONCLUSION ON FIRST COMPLAINT

35. The Committee has borne in mind the provisions in paragraphs 4 and A3 of HKSQC 1. While the nature and extent of the policies and procedures to comply with HKSQC 1 may depend on various factors such as the size of the firm and that documentation and communication policies and procedures for smaller firms may be less formal, such policies and documents must be clear and effective. The PRC which has carried out the 2 reviews has formed the view that the Respondent failed to have the necessary policies and procedures satisfying the requirements of relevant parts of HKSQC 1. The evidence available to the Committee points to the conclusion that any policies and procedures, if existed, are far from meeting the requirements of HKSQC 1.

36. In view of the above, the Committee is satisfied that the Respondent has failed to establish policies and procedures with reasonable assurance for adequate quality control in respect of monitoring, client acceptance and continuance, and engagement performance, as required under HKSQC 1.

Section D – SECOND AND THIRD COMPLAINTS

37. Paragraph 6 of Hong Kong Standard on Auditing 500 "*Audit Evidence*" (Revised July 2010)("**HKSA 500**") provides as follows:

> "*6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.*"

38. The Complainant states that in the Initial Review, the audit working papers of Client S and Client Y of the Practice were reviewed by the PRC. Various deficiencies were found and drawn to the attention of the Practice. In response, the Practice undertook to take remedial actions. However, when the 2013 Working Papers were reviewed in the 2nd Review, the practice reviewer found that the Practice failed to

obtain sufficient appropriate audit evidence on various matters and some of these were recurring from the Initial Review. Such deficiencies are set out and discussed in the following paragraphs in this Section.

(1) ASSESSMENT PROCEDURES (CLIENT'S KEY INTERNAL CONTROL):

The Complaints
Assessment Procedures under paragraph 13 of HKSA 315 *"Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment"*

Audits of Client S and Client Y

39. During the Initial Review, it was found that the Practice did not perform adequate evaluation of the design and implementation of clients' key controls. The Respondent undertook to prepare evaluation sheets in future.

40. However, in the 2nd Review when the 2013 Working Papers of Client S and Client Y were reviewed, the practice reviewer found no evidence that the Practice had performed procedure to evaluate the design of these Clients' internal controls relevant to the audit and determine whether those controls had been properly implemented in the audit period.

Respondent's Response

41. The Respondent had the following response to the complaint on Assessment Procedures (Client's Key Internal Control) for the audits of Clients S and Y.

    (a) In letter dated 15 July 2013, the Respondent admitted that the directors of the Clients took up the responsibility of internal control, so evaluation of internal control was not seriously carried out by the Practice. The Respondent promised that the internal control evaluation work sheet would be prepared in future.

    (b) In its response to the 2nd Review Report, the Respondent claimed that the conclusion of its evaluation of the design of internal control was that the clients were director-controlled system of private companies.

    (c) In a letter dated 14 October 2015, the Respondent claimed that he had audited the accounts of the 2 clients for over 5 years and had

deep knowledge of their key controls and fraud risk areas. It was possible that the evaluation form and fraud risk assessment had been written for his own use which may be unclear to other people.

Discussion

42. The Committee notes the following in the Risk Assessment/Audit Planning forms of Clients S and Y, amongst the 2013 Working Papers:

(a) There is no mention of the need to understand the clients' internal control, in order to identify and assess the risks of misstatement at the financial statement and assertion levels.

(b) There is no mention of any procedure to be performed by the Practice to evaluate the design of those controls relevant to audit and determine whether they have been implemented.

(c) The only procedures that are stated to be performed to identify misstatement are those in relation to misstatement at assertion level for individual account balances and transactions.

(d) In the Risk Assessment form of Client S, there is only a single statement of "*Controlled by managing director*" under the heading of "*Internal Control*".

(e) In the Risk Assessment form of Client Y, there is only a single statement of "*Wholly controlled by directors and family members*" under the heading of "*Internal Control*".

43. The Committee also notes the following amongst the 2013 Working Papers:

(a) In the document entitled "*Summary Review Memorandum*" of Client Y, it was stated that Client Y was considered to be a risk-free company for several reasons. However, none of these reasons show that Client Y's internal key control had been reviewed.

(b) In the document entitled "*APM Summary*" of Client S among the 2013 Working Papers, there is only a single statement of "*wholly controlled by the directors*" under the heading of "*Management system*". In the document entitled "*APM*" of Client Y among the 2013 Working Papers, there is only a single statement of "*closed controlled by family members*" under the same heading. There was no evidence of evaluation of such internal control.

Conclusion

44. In the light of the above, the Committee concludes that the Respondent has not performed procedures for understanding the clients and their environment for identifying and assessing the risk of material misstatements for his audits of Clients S and Y for the year ended 31 March 2013.

(2) RISK ASSESSMENT (FRAUD):

The Complaints:
Risk Assessment procedure under HKSA 240
***"The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"* (Revised July 2010)**

Audits of Clients S and Y

45. During the Initial Review, the Practice was found to be not performing and documenting its assessment of fraud risk. The Respondent agreed to comply with HKSA 240 and to undertake an assessment in future audits.

46. When the 2013 Working Papers of Client S was reviewed in the 2nd Review, the practice reviewer found no evidence for compliance with HKSA 240, such as (i) obtaining information for use in identifying and (ii) assessing risk of material misstatement due to fraud relating to revenue recognition and management override of controls.

Respondent's Response

47. In response to the Initial Review Report, the Respondent claimed that fraud risk assessment had been performed, not for individual client but for groups of clients. The Respondent admitted that there was no fraud risk assessment worksheet for individual files and promised to ensure that the fraud risk assessment worksheet would appear in every audit file.

48. In response to the 2nd Review Report, the Respondent explained that audit procedures in area of fraud risk were greatly reduced. This was because the companies were private companies which were free to deal with their funds and, being directors-controlled companies, took up the responsibility in detecting fraud.

49. In the Respondent's Case dated 30 June 2016, the Respondent claimed that there is a schedule specially prepared for the topic of fraud risk in the files.

Discussion

50. Although the Respondent claims that there is a schedule prepared for the topic of fraud risk, he has not referred to the Committee such schedule.

51. The Committee notes that there are documents in the 2013 Working Papers which did mention in some way something about fraud risk or risk assessment, for instance those as set out in paragraphs 42 and 43 above. However, the Committee takes the view that these do not show that adequate risk assessment procedure as required under HKSA 240 had been performed.

52. Apart from the above, the Respondent has not shown to the Committee any documentation showing fraud risk assessment procedure.

Conclusion

53. The Committee is satisfied that the Respondent failed to carry out adequate assessment of fraud risk for his audits of Clients S and Y for the year ended 31 March 2013.

(3) ACCOUNTING TREATMENT OF BANK BORROWINGS:

The Complaint:
Assessment of whether accounting treatment of bank borrowings was in accordance with section 11 of Hong Kong Financial Reporting Standard for Private Entities ("HKFRS-PE")
"Basic Financial Instruments"

Audit of Client S

54. According to the 2013 Working Papers of Client S, discounted bills were offset against the accounts receivable upon receipt of cash. There was no evidence of work to ascertain the nature and terms of the discounted bills and assess whether the offsetting was in accordance with section 11.34 of HKFRS-PE.

55. Section 11.5(d) of HKFRS-PE indicated that accounts receivable is a financial instrument. Client S retained contractual rights to receive cash flows from debtors and a contractual obligation to pay those cash flow to the banks. Under section 11.34 of HKFRS-PE, Client S should have continued to recognize the full amount of accounts receivable and the consideration received for the discounted bills as a financial liability.

Respondent's Response

56. In his response to the 2nd Review Report, the Respondent explained that in respect of bills discounted, Client S de-recognized the financial asset of accounts receivable and, though normally there should be a note of the contingent liability because the relevant bank can claim Client S in case of bad debt, at the time of audit, it was clear that there was no such liability and so no additional note of the contingent liability was shown.

57. In letter dated 21 September 2015, the Respondent claimed that discounted bills should be covered in Section 21 - provisions and contingencies of HKFRS-PE as contingent liability. The Respondent claimed that probable liability as at the reporting date should be recognized, whilst contingent liability such as discounted bills should not. The Respondent contended that if the transaction of discounted bills is completed by the financial institution receiving reward under the discounted bills, it is not reversible and it is no longer necessary to re-state the discounted bills as the right of reversing the transaction as contingent liability.

58. In letter dated 14 October 2015, the Respondent claimed that the Practice made choice based on judgment on risk to treat discounted bills by evaluating the risk of contingent liability whether to treat discounted bills as contingent liability.

59. In the Respondent's Case dated 30 June 2016, the Respondent claimed that Client S had sold debtors' bills to the banks and as the banks had collected the money and Client S had no liability, Client S does not need to recognize the liability to the Bank.

Discussion

60. Section 11.5(d) of HKFRS-PE indicated that accounts receivable is a financial instrument. Client S retained contractual rights to receive cash flows from debtors but was under a contractual obligation to pay those cash flow to the banks. Under section 11.34 of HKFRS-PE, Client S should have continued to recognize the full amount of accounts receivable and the consideration received from the bank for the discounted bills as a financial liability.

61. The Complainant's case in respect of the discounted bill treatments is based on section 11.34 of HKFRS-PE which is concerned with de-recognition rather than section 21 of HKFRS-PE which is concerned with disclosure of liability. Despite the clear statement of the issue involved in the 2nd Review Report by the Complainant, the Respondent failed to address the issue under section 11.34 of HKFRS-

PE but kept on arguing that the discounted bill treatment is in line with the requirement for disclosure in section 21 of HKFRS-PE. This demonstrates the Respondent's lack of knowledge of the issue involved in accounting standard which in turn indicates that the Respondent failed to see the need to obtain the appropriate evidence to address properly the relevant issue. All these indicate that there were no appropriate audit procedures in place for obtaining sufficient appropriate audit evidence from the client to address the appropriate audit issue for the Respondent to form his professional view.

62. In the financial statements, Client S derecognized the accounts receivable related to the discounted bills. The Bank Confirmation indicated that Clients S had bills discounted to the bank in the total sum of about HK$2 million and the corresponding trade debtors were de-recognized upon receipt of cash by Client S from the bank.

63. However, the Committee cannot find from the financial statements or the 2013 Working Papers relevant information, such as the terms and conditions for the discounted bills or the policy for the accounting treatment of discounted bills of Client S, to justify and explain why the accounts receivable are qualified for de-recognition. It indicates that the Respondent had not performed the proper procedure to consider whether to agree to the de-recognition of the accounts receivable by the management of Client S.

Conclusion

64. The Committee is satisfied that the treatment of discounted bills by Client S was inappropriate and the Practice has failed to perform audit procedure for the purpose of obtaining sufficient appropriate audit evidence on the accounting treatment.

(4) ACCOUNTING TREATMENT OF INVESTMENT PROPERTY:

The Complaint
Assessment of whether the accounting treatment of investment properties was in accordance with Section 16 of HKFRS-PE "*Investment Property*"

Audit of Client Y

65. In the Initial Review, it was found in the working papers of Client Y for the year ended 31 March 2012 which showed that certain properties held by Client Y had been leased out to independent third parties to earn rental income since acquisition, and such properties were classified as property, plant and equipment instead of investment

properties in the statement of financial position. This was pointed out to the Practice and the Practice promised to ensure proper classification in the subsequent audit.

66. During 2nd Review when the 2013 Working Papers of Client Y were reviewed, the practice reviewer found no evidence of work done by the Respondent to determine the nature and purpose of the properties and ascertain whether the accounting treatment was in accordance with section 16 of HKFRS-PE.

67. Investment properties should be accounted for under section 16 of HKFRS-PE which required properties whose fair value can be measured reliably without undue cost or effort to be initially recognized at costs and subsequently at fair value. The cost-depreciation-impairment model under section 17 of HKFRS-PE can be used only where the fair value of properties cannot be measured reliably without undue cost or effort. There was no evidence of work done by the Practice to justify why the accounting treatment of the "investment properties" at costs under section 17 of HKFRS-PE was appropriate.

Respondent's Response

68. In a letter dated 21 September 2015, the Respondent stated that the Investment Properties were stated at cost basis and so they are included in property, plant and equipment in accordance with section 17 of HKFRS-PE and not shown separately as investment properties as required under section 16 of HKFRS-PE.

69. In the Respondent's Response dated 14 October 2015, the Respondent stated that the choice in respect of investment property was based on Client Y's choice, to avoid undue cost in valuation.

70. In the Respondent's Case dated 30 June 2016, he stated that cost needs to be incurred to assess fair value, and that will cause big trouble for small company like Client Y.

Discussion

71. The Committee accepts that investment properties should be accounted for under section 16 of HKFRS-PE which required properties whose fair value cannot be measured reliably without undue cost or effort to be initially recognized at costs and subsequently at fair value. The cost-depreciation-impairment model under section 17 of HKFRS-PE can be used only if the fair value of investment properties cannot be measured reliably without undue cost or effort.

72. The Committee opines that as an auditor is undertaking an independent role in performing the audit work, the Practice should not wholly rely on the assessment made by the directors of Client Y but should assess the relevant accounting treatment independently.

73. There was no evidence of work done by the Practice to justify the nature and purpose of the properties concerned, as well as to justify why the accounting treatment of the investment properties at costs under section 17 of HKFRS-PE was appropriate. The Committee also could not find evidence in the 2013 Working Papers showing that the Practice had made the necessary effort to obtain the audit evidence to ascertain the decision of the directors of Client Y treating the properties as property, plant and equipment was the correct one.

Conclusion

74. The Committee is satisfied that the Practice has failed to perform audit procedure required for the purpose of obtaining sufficient appropriate audit evidence to meet the requirement on the accounting treatment of investment property.

(5) CONCLUSION ON SECOND AND THIRD COMPLAINTS

75. The Committee is satisfied that the Respondent failed to design and/or perform audit procedures that are appropriate for the purpose of obtaining sufficient appropriate audit evidence in relation to the audits of the financial statements of Clients S and Y respectively for the year ended 31 March 2013, as detailed in paragraphs 37 to 74 above.

Section E – FOURTH AND FIFTH COMPLAINTS

76. Paragraph 5 of Hong Kong Standard on Auditing 230 "*Audit Documentation*" (Revised July 2010) ("**HKSA 230**") provides as follows:

> "*5. The objective of the auditor is to prepare documentation that provides:*
> *(a) A sufficient and appropriate record of the basis for the auditor's report; and*
> *(b) Evidence that the audit was planned and performed in accordance with HKSAs and applicable legal and regulatory requirements.*"

77. The Complainant states that the Respondent failed to prepare documentation in respect of various aspects in its auditing work for Clients S and Y for the year ended 31 March 2013. Such failures are set out and discussed in the following paragraphs in this Section.

(1) MATERIALITY AND PERFORMANCE MATERIALITY:

The Complaint
Materiality and Performance Materiality

Audits of Clients S and Y

78. In the Initial Review, it was found that the Practice did not determine a materiality level for its audits in accordance with HKSA 320 "*Materiality in Planning and Performing an Audit (Revised July 2010)*". The Practice undertook to document the basis of materiality level to be adopted in future audits.

79. During the 2nd Review, it was found that the 2013 Working Papers provided no documentation of how the Practice had:

(a) assessed the risk of material misstatement; and

(b) determined the materiality applicable for determining the nature, timing and extent of audit procedures.

Respondent's Response

80. In his response to the Initial Review Report, the Respondent considered that the audit risk was low because the clients are small companies and so the Practice has set such blanket materiality level of 5% as written in the audit planning memorandum.

81. In response to the 2nd Review Report, the Respondent claimed that the users of financial statements of the Clients were directors and Inland Revenue Department, and the financial statements would not be disclosed to the public. So the Practice designed materiality level based on these users requirements.

82. In letter dated 21 September 2015, the Respondent stated that the level of materiality was determined based on his professional judgment.

83. In letter dated 14 October 2015, the Respondent claimed that the decision on materiality was based on the Respondent's past experience and judgment.

84. In the Respondent's Case dated 30 June 2016, the Respondent claimed that materiality level had been stated in the working papers for audit planning.

Discussion

85. The Committee notes that the Respondent admitted in his letter dated 15 July 2013 that there was no written statement on the basis of materiality level and the Practice undertook to cause written decision of the basis of materiality level be adopted in every file.

86. The Committee notes that an item of "*Materiality*" appeared in the document entitled "*APM Summary*" of Client S and the document entitled "*APM*" of Client Y amongst the 2013 Working Papers. However, the 5% as alleged by the Respondent does not appear in either of these 2 documents. The Respondent could not provide explanation to account for such discrepancy during the substantive hearing. So there is no record of the materiality level of 5% in the 2013 Working Papers for audit planning as claimed by the Respondent.

87. The Committee also could not find in the 2013 Working Papers any documentation of how the Practice had assessed the risk of material misstatement nor is there any documentation showing how the said materiality level (which is stated in the same absolute amount of HK$50,000 in the 2013 Working Papers) for both Clients S and Y was determined.

Conclusion

88. In paragraph 14 of HKSA 320, an auditor is required to document the factors considered in the determination of materiality. The Committee found that there was no adequate documentation of the basis of determination of materiality and performance materiality required under HKSA 320.

(2) SAMPLE SIZE AND SELECTION OF ITEMS FOR TESTING:

89. According to HKSA 530 "*Audit Sampling*" (Revised July 2010), the objective of the auditor when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

The Complaint in respect of the Audit of Client S

90. In the Initial Review, the practice reviewer pointed out that the Practice did not perform sufficient audit work on trade creditors, sales and purchases.

91. In the 2nd Review, the practice reviewer found that the 2013 Working Papers indicated that the Practice performed the following audit procedures without documentation of the basis for sample size and selection:

(a) Circularisation of 2 creditors representing 5% of the year end accounts payable balance of about HK$7.9 million;

(b) Substantive testing of 5 samples of turnover and purchases representing 0.09% and 0.09% of the total amount for the year of approximately HK$167 million and HK$131 million respectively.

92. In the circumstances, the 2013 Working Papers provided insufficient record of how the Practice complied with the sampling requirements under paragraphs 6 to 8 of HKSA 530 as set out in paragraph above, which required the auditor to:

(a) Consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn when designing an audit sample;

(b) Determine a sample size sufficient to reduce sampling risk to an acceptably low level; and

(c) Select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Respondent's Response

93. In response to the Initial Review Report, the Respondent stated that additional samples would be selected for testing in the following year.

94. In the letters dated 21 September 2015 and 14 October 2015, the Respondent stated that the sample size and selection of items for testing were based on his judgment and past experience with the client.

95. In his letter dated 14 October 2015, the Respondent claimed there was work done but no detailed statistical method and figures were presented.

96. In the Respondent's Case dated 30 June 2016, the Respondent claimed that the sampling method in auditing the Clients was random sampling which was allowed by the Standard.

Discussion

97. The Committee notes that the Respondent admitted in the said letter dated 15 July 2013 that circularisation of confirmation to trade creditors was not carried out and the Respondent promised to send creditor's confirmation in future. In such letter the Respondent also agreed that, in response to the practice reviewer's comment that the sample size for sale and purchase was too small, additional samples would be selected for the following year, and checking with delivery/shipping of goods included in sales/purchase tests.

98. Despite such promise, there was still no record of such sampling method in the 2013 Working Papers.

99. Paragraph 5 of HKSA 230 requires an auditor to prepare documentation that provides sufficient and appropriate record of the basis for the auditor's report.

100. Though the Respondent claimed that the sampling method was random sampling, there is no record of the relevant methodology or the carrying out of the selection process by such random sampling.

101. The 2013 Working Papers showed that the sampling was only a small percentage in value as compared to the total accounts payable and turnover. In the absence of documentation of the basis for the small sample size, there is doubt whether such sampling would be sufficient to indicate that an appropriate sampling method had been adopted for providing the necessary audit evidence. The admission by the Respondent that the sampling method was based on his judgment and experience without stating what sampling method was adopted or any consideration involved in adopting such method further reinforced this conclusion.

Conclusion

102. The aforesaid indicates that the Practice is in breach of HKSA 230.

The Complaint in respect of Audit of Client Y

103. In the Initial Review, the practice reviewer found that the Practice did not perform sufficient audit work to assess the recoverability of a material amount due from a related company and the relationship

between the related company and Client Y. The Practice accepted that it had neglected to document the matter.

104. In the 2nd Review, the practice reviewer found from the 2013 Working Papers that the Practice still neglected to perform adequate work to assess the recoverability of the material amount due from a related company and document the relationship between the related company and Client Y.

105. In the circumstances, the 2013 Working Papers provided insufficient record of how the Respondent complied with the sampling requirements under paragraphs 6 to 8 of HKSA 530 as set out in paragraph 92 above.

Respondent's Response

106. In his response to the Initial Review Report, the Respondent stated that the related company which owed money to Client Y was under the control of Client Y, and the Respondent had knowledge of the soundness of the finance of the related company but the Respondent neglected to state his such knowledge in the audit file of Client Y.

107. In the Respondent's Case dated 30 June 2016, the Respondent stated that he had told the practice reviewer that the related company's accounts were audited by him, and that he had more than sufficient documents to support his audit in that regard.

Discussion

108. The Respondent has not referred to any documentation in the 2013 Working Papers that he had assessed the recoverability of the material amount due from the related company. Rather, the Respondent claims that audit work was sufficient as he knew the client and the related company and had carried out audit work for them.

109. The issue in this complaint is not whether the result of the audit was correct or sufficient, but rather whether there was proper documentation of the process of the audit.

Conclusion

110. It is clear that the Respondent failed to keep the necessary audit documentation in respect of his assessment of the recoverability of the debt.

(3) ASSESSMENT OF DEFERRED TAXATION:

The Complaint
Audits of Clients S and Y

111. The 2013 Working Papers do not contain documentation of whether the Practice had performed work to ascertain whether deferred taxation was appropriately recognized by Clients S and Y for all taxable temporary differences in accordance with section 29 of HKFRS-PE "*Income Tax*".

Respondent's Response

112. In his response to the 2nd Review Report, the Respondent admitted that the Respondent did not record in writing the details of the Practice's calculation on the deferred tax.

113. In his letter dated 21 September 2015, the Respondent sought to explain the reasons for not providing for deferred taxation.

114. The Respondent also claimed in the Respondent's Case dated 30 June 2016 that the basis for not providing for deferred taxation was as stated in the financial statements in that the deferred taxation was considered to be not material. Also, following the change of the Companies Ordinance, both companies could dispense with deferred taxation in their accounts.

Discussion

115. In the Respondent's Case dated 30 June 2016, the Respondent does not seem to dispute that the 2013 Working Papers contained no documentation of his rationale for concurring with Client S that deferred taxation need not be recognized for the year ended 31 March 2013 in accordance with section 29 of HKFRS-PE.

116. In his response to the 2nd Review Report, the Respondent admitted that the Respondent did not record in writing the details of the Respondent's calculation on the deferred tax, despite the Respondent's view that the taxation aspect of their client was simple and could be calculated.

117. The Respondent has not referred the Committee to any record of calculation of the deferred taxation in the 2013 Working Papers.

118. The relevant provisions of the new Companies Ordinance (Cap. 622) came into effect on 3 March 2014, after the date of the audit period in question.

Conclusion

119. The Committee is satisfied that the Respondent failed to keep proper documentation for his assessment of deferred taxation.

(4) CONCLUSION ON FOURTH AND FIFTH COMPLAINTS

120. The Committee notes that there were lengthy discussions in the Submissions about the rationale for audit treatments of various matters mentioned above. There were indeed certain treatments that called for special attention. Whether the decisions taken by the Respondent was correct or proper is not the main issue in these two Complaints.

121. The main issue in these two Complaints is the lack of documentation. It was because of the special nature of the decisions that called for assessment and the rules required such assessment to be properly documented.

122. The Committee is satisfied that the Respondent failed to adequately document the evidence obtained and procedures performed in relation to the audits of the financial statements of Client S and Client Y for the year ended 31 March 2013.

Section F – CONCLUSION

123. Based on the reasoning as set out above, the Committee is satisfied that all of the Five Complaints were proved by the Complainant.

Section G – SANCTION

124. Having regard to all the aforesaid matters, including the particulars in support of the Complaints, the submissions on sanction and costs of the Complainant and the Respondent respectively and his conduct throughout the proceedings, the Committee makes the following ORDERS:-

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

(b) the practising certificate issued to the Respondent be cancelled under section 35(1)(da) of the PAO, effective from the 42nd day after the date hereof under section 35(1)(a) of the PAO;

(c) a practising certificate shall not be issued to the Respondent for 18 months commencing from the 42nd day after the date hereof under section 35(1)(db) of the PAO;

(d) the Respondent pay a penalty in the total sum of HK$50,000 under section 35(1)(c) of the PAO; and

(e) the Respondent pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK$110,094 and that of the Clerk in the sum of HK$18,542 under section 35(1)(iii) of the PAO.

Mr. CHOW, Cheuk Yu, Alfred
(Chairman)

Miss WOO, Lee Wah, Cecilia

Mr. WONG, Chun Bong, Alex

Mr. WONG, Sai Hung, Oscar

Mr. CHAN, Stephen