

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

SO Kwok Keung, Keith (F01702) RESPONDENT

Before a Disciplinary Committee of the Hong Kong Institute of Certified
Public Accountants

Members: Ms. LAU Shing Yan (Chairman)
Mr. AU YEUNG Wai Lun, Kelvin
Mr. CHAN Raymond
Mr. DONOWHO Simon Christopher
Mr. YEUNG Chi Wai, Edwin

ORDER AND REASONS FOR DECISION

1. This is a complaint made by the Practice Review Committee of the Hong Kong Institute of Certified Public Accountants (“**the Institute**”) against Mr. So Kwok Keung, Keith, a practising certified public accountant (“**the Respondent**”).

2. By a letter dated 9 January 2017 to the Council of the Institute (“**the Complaint**”), the Practice Review Committee (“**the Complainant**”) complained that the Respondent failed or neglected to observe, maintain or otherwise apply professional standards under section 34(1)(a)(vi) of the Professional Accountants Ordinance (“**PAO**”).
3. On 8 March 2017, the Respondent confirmed his admission of the complaints against him and he did not dispute the facts as set out in the Complaint. The parties jointly proposed that the steps set out in paragraphs 17 to 30 of the Disciplinary Committee Proceedings Rules (“**the Rules**”) be dispensed with.
4. In view of the Respondent’s admission, the Disciplinary Committee acceded to the parties’ joint application to dispense with the steps set out in paragraphs 17 to 30 of the Rules and directed the parties to make written submissions on sanctions and costs.
5. On 29 June 2017, the Complainant and the Respondent made their respective submissions on sanctions and costs.

Background

6. The Respondent is a practising director of East Asia Sentinel Limited (Corporate Practice no. M032) (the “**Practice**”).
7. The Practice had been selected for its third practice review in July 2015. The practice review is a quality assurance program which is conducted by the Institute’s Quality Assurance Department (“practice reviewer” or “reviewer”).
8. The reviewer identified significant findings in the audit of a listed company, namely Extrawell Pharmaceutical Holdings Limited, for the year ended 31 March 2014 (“**Client E**”).
9. The Respondent, being the engagement director of Client E, issued the corresponding auditor’s report in the name of the

Practice and was therefore responsible for the quality of the audit engagement.

10. The reviewer noted that prior year adjustments were made in the financial statements of Client E for the year ended 31 March 2015, which was audited by another auditor, to restate the fair value of convertible bonds (“CB”) issued in 2014 as partial consideration for the acquisition of additional interests in a subsidiary of Client E.
11. In relation to the CB’s valuation performed in 2014, the reviewer found that the Respondent did not perform sufficient audit procedures and adequately document the procedures performed on the work of an expert who conducted the valuation of CB on the issue date of 16 July 2013 (“**Issue Date**”).
12. Based upon the practice review findings, the reviewer issued a letter on 23 November 2015 to invite the Practice to respond to the dated draft Reviewer’s Report.
13. Based on the findings in the Reviewer’s Report and the response from the Practice, the Practice Review Committee considered that the audit work carried out by the Respondent for the audit engagement of Client E shows a significant non-compliance with the professional standards and decided to raise a complaint against the Respondent.

Relevant Professional Standards

14. The following professional standards are relevant and applicable to this complaint:

- (1) Hong Kong Standard on Auditing 500 “*Audit Evidence*” (May 2013) (“**HKSA 500**”)

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

“8. If information to be used as audit evidence has been prepared using the work of a management’s expert, the auditor shall, to the extent necessary, having regard to the significance of that expert’s work for the auditor’s purposes:

- (a) Evaluate the competence, capabilities and objectivity of that expert;
- (b) Obtain an understanding of the work of that expert; and
- (c) Evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertion.”

(2) Hong Kong Standard on Auditing 230 “*Audit Documentation*” (May 2013) (“**HKSA 230**”)

“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.”

The Complaints

First Complaint

15. 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 professional standards namely, paragraphs 6 and 8 of HKSA 500 in that he had failed to design and/or perform audit procedures that are appropriate for the purpose of obtaining sufficient appropriate audit evidence in relation to the fair value measurement of CB on the Issue Date.

Second Complaint

16. 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 fair value measurement of CB on the Issue Date.

Breach of HKSA 500

17. According to paragraph 6 of HKSA 500, an auditor is required to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.
18. Paragraph 8 of HKSA 500 provides that if the work of a management's expert is to be used as audit evidence, an auditor is required to obtain an understanding of the work of that expert and to evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. Further guidance is provided in A34 – A48 of HKSA 500.
19. The CB had a principal amount of HK\$641,300,000 which comprises the liability and equity components. In the financial statements for the year ended 31 March 2015, Client E had restated the fair value of the liability component from HK\$126.9 million to HK\$21 million and the equity component from HK\$514 million to HK\$569 million.
20. Paragraph B96 of HKFRS 10 "*Consolidated Financial Statements*" provides that the accounting for changes in the proportion held by non-controlling interests requires determining the fair value of consideration paid. Therefore, upon the acquisition of an additional interest in a subsidiary that would change the proportion held by non-controlling interests, there is a need to ascertain the fair value of the consideration paid which in this case is the fair value of the CB as a whole.

21. Paragraphs 31 and 32 of HKAS 32 "*Financial Instruments: Presentation*" provide that when the carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.
22. Based on the Respondent's working papers for Client E, the reviewer noted that the CB's fair value on the Issue Date was determined by an independent valuer. The valuation method entailed deriving a residual amount for the equity component by subtracting the CB's principal amount from the present value of the liability component which was calculated using a discount rate of 8.43% ("**First Valuation**").
23. According to the working papers, the discount rate of 8.43% was made up of four components, which are percentages of the risk-free rate, CB Premium, liquidity risk and business risk. Except for the risk-free rate, there was no evidence of audit work having been done by the Respondent on the remaining three components.
24. There was no evidence that the Respondent had (i) challenged the appropriateness of the First Valuation method which did not ascertain the fair value of the CB as a whole; and (ii) assessed the reasonableness of the components which make up the discount rate used in the valuation of the CB's liability component.
25. In the letter dated 15 August 2016, the Respondent stated that a second valuation of the same CB with a valuation date of 31 December 2012 was performed by another valuer for the purpose of a proposed acquisition of CB by another listed entity in September 2013 ("**Second Valuation**"). He decided not to test all components in the discount rate because:

- (1) On comparing with the results of the First and Second Valuations, the Respondent noted that the discount rates used in both valuations were not materially different.
- (2) The different valuation methods used in the First and Second Valuations did not result in any material difference in the CB's fair values on the Issue Date (i.e. 16 July 2013) and on the valuation date of the Second Valuation (i.e. 31 December 2012).

Based on the above comparisons, the Respondent considered that the discount rate of 8.43% and the valuation method of the First Valuation adopted by Client E is acceptable.

26. The Respondent did not perform adequate audit procedures for the purpose of obtaining sufficient appropriate evidence to support the CB's fair value in his audit because:

- (1) Without performing any audit procedures to understand and assess the reasonableness of each key component -- other than the risk-free rate -- in the discount rate, there is insufficient audit evidence to support that the discount rate used in the First Valuation was appropriate. The Second Valuation could not provide the basis of a valid comparison because, inter alia, the requisite audit procedures had not been performed on that valuation, and there was an approximately half-year difference in the valuation dates.
- (2) The Respondent also did not assess the appropriateness of the valuation method and assumptions used to derive the discount rate of the Second Valuation. Without such an assessment, there is insufficient evidence to support that the basis for comparisons between the First and Second Valuations were reasonable.

27. On the basis of the above, the Respondent has failed to comply with paragraphs 6 and 8 of HKSA 500 in respect of the audit of the CB.

Breach of HKSA 230

28. According to paragraph 5 of HKSA 230, an auditor is required to prepare audit documentation that provides sufficient and appropriate record.
29. The working papers indicated that the Practice had discussed with the valuer of the First Valuation and accepted his opinion that the valuation inputs are reasonable. However, there was no documentation of such an assessment done by the Practice and the rationale based on which the Practice had concluded that the First Valuation is reasonable.
30. In the letter dated 15 August 2016, the Respondent stated that he had discussed the valuation approach and inputs with valuer of the First Valuation. In addition, he had assessed the reasonableness of the CB's valuation by comparing the methodologies and valuation inputs used in the First and Second Valuations.
31. Notwithstanding the Practice's response, there was no documentation of such assessments and comparisons performed by the Practice. Therefore, the Practice has failed to comply with paragraph 5 of HKSA 230 to prepare adequate audit documentation.

The Parties' Submissions on Sanctions and Costs

32. Both the Complainant and the Respondent agree that the Disciplinary Committee should impose a penalty in the form of a reprimand and a fine. However, the parties are in dispute as to the appropriate amount of the fine.
33. In their letter of 29 June 2017, the Complainant points out that the fair value of the CB was restated which demonstrates that the CB had been materially misstated in 2014. According to Client E's 2015 annual report, this restatement resulted in an increase in profits of HK\$3.2 million and increase in the earnings per share in

the range from HK\$0.1- \$0.13. The Complainant submits that in view of the public interests involved in this audit of a listed company, the case is serious and the level of sanctions should reflect this assessment. It is suggested that an appropriate sanction should include a reprimand and a financial penalty of an amount within the range of HK\$60,000 to HK\$80,000.

34. In this connection, the Complainant has referred to two cases, namely Proceedings No. D-14-0988F and Proceedings No. D-12-0712X, wherein in both cases the respondents were found to have failed to comply with professional standards in audits of listed companies involving the valuation of convertible bonds.
35. The Complainant also submits that the Respondent should pay the costs and expenses of and incidental to the proceedings of the Institute (including the costs and expenses of the Disciplinary Committee). The Complainant has provided a Statement of Costs dated 29 June 2017 which states a total of HK\$33,004.
36. The Respondent, on the other hand, invites the Disciplinary Committee to impose a penalty in the form of a reprimand and a fine not exceeding HK\$50,000. The Respondent is also willing to pay for the costs of the proceedings incurred by the Complainant on a “party and party basis” as well as the costs of the Disciplinary Committee.
37. The Respondent gave reasons in support of his proposal and they are summarised as follows:
 - (1) The Complaint concerns a breach of section 34(1)(a)(vi) of the PAO only and does not involve any professional misconduct or dishonesty.
 - (2) The Respondent admitted that he did not fully observe, maintain or otherwise apply the professional standards expected of him and he is sincerely remorseful about the breach.

- (3) The Respondent duly admitted the Complaint at the earliest available opportunity on 8 March 2017 and has been co-operative in the investigations.
 - (4) No loss or prejudice has been suffered by Client E and the investing public, and the Respondent's non-compliance of the relevant professional standards did not result in Client E's reported profit or loss for the subject year being misstated.
38. On 12 July 2017, the Respondent responds to the Complainant's submissions and contends that the restated increase in profits for the subject company was due to (1) non-cash imputed interest amortised on the liability component of the CB; and (2) the restated increase in earnings per share should have been in cents rather than in dollars.
 39. By a letter dated 14 July 2017, the Complainant accepts that the increase in earnings per share should be in cents rather than in dollars, and explains that its statement that the profit increase of HK\$3.2 million could be attributed to the restatement of the CB was based upon information extracted from Note 44(a) of Client E's 2015 annual report.
 40. The Disciplinary Committee did not receive any further submissions or statements from the parties.

Decision

41. The Disciplinary Committee notes that it has a wide discretion on the sanctions it might impose. Each case is fact sensitive and the Disciplinary Committee is not bound by the decision of a previous committee.
42. In this case, although there is no direct evidence that the subject company's profit and loss had been materially misstated as a result of the Respondent's non-compliance of the relevant professional standards, there is no doubt that significant public

interest was at stake in the audit of the subject listed company and the quantum of the fine should reflect this aspect of the case.

43. Having considered the all the relevant facts of the Complaint, the parties' submissions, the Respondent's conduct throughout the proceedings and his personal circumstances, the Disciplinary Committee considers that a financial penalty of HK\$60,000 is appropriate.
44. As for costs, the Disciplinary Committee considers that the sum of HK\$33,004 was incurred reasonably and should be borne by the Respondent.
45. The Disciplinary Committee makes the following order:
 - (1) The Respondent be reprimanded under section 35(1)(b) of the PAO;
 - (2) The Respondent do pay a penalty of HK\$60,000 pursuant to section 35(1)(c) of the PAO;
 - (3) The Respondent do pay the costs and expenses of and incidental to the proceedings of the Complainant (including the costs of the Disciplinary Committee) in the total sum of HK\$33,004 under section 35(1)(iii) of the PAO.

Dated the 1st day of September 2017.