

IN THE MATTER OF

Complaints made under Section 34(1)(a) of the Professional Accountants Ordinance (Cap.50) (“the PAO”) and referred to the Disciplinary Committee under Section 33(3) of the PAO

BETWEEN

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

COMPLAINANT

AND

The Respondent

RESPONDENT

Before a Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants (“the Institute”)

Members:

REASONS FOR DECISION

1. This is a complaint made by the Practice Review Committee (the "**PRC**") of the Hong Kong Institute of Certified Public Accountants (“the Institute”) as Complainant against the Respondent, a certified public accountant to whom Section 34(1)(a)(vi) of the PAO applies.
2. By a letter dated 6 April 2011, the PRC of the Institute submitted its complaints against the Respondent to the Council of the Institute for considerations of referral to the Disciplinary Panels under Section 34(1) of the PAO (the “**Complaint**”). The particulars of the Complaint brought to the attention of the Disciplinary Panels are recited verbatim in the following paragraphs 3 to 83 of this Reasons for Decision, subject to minor amendments and updating. Reference to Appendix hereinafter is reference to the Appendix to the Complaint.

Background to the Complaint

3. The Respondent is a former director of [Corporate Practice P] (corporate practice number [Xxxx]) (“**[Corporate Practice P]**”). [Corporate Practice P] is a corporate practice registered with the Institute. [Corporate Practice P] was subject to a first practice review in September 2008 (**Appendix 1.1**). The PRC, after considering the findings of the first practice review, directed that another practice review be conducted on [Corporate Practice P] pursuant to section 32D(3) of the PAO. The Respondent was notified of the PRC's direction on 11 December 2008 (**Appendix 1.2**).
4. A second practice review was carried out in October 2009 and continued shortcomings in [Corporate Practice P]'s audit engagements for listed companies were noted (**Appendix 1.3**). Subsequently, the Quality Assurance Department was directed to conduct a further visit to [Corporate Practice P] to clarify and obtain information on matters that continued to concern the PRC. Accordingly, a Supplementary Report to the PRC setting out the findings of second practice review (the "**Supplemental Report**") (**Appendix 1.4**) was produced.
5. At all materials times the Respondent was, and still is, a practising member of the Institute and was the sole practising director of [Corporate Practice P] responsible for all audit engagements until he ceased to be a director on 10 May 2010.
6. The PRC, having considered both the Supplemental Report and the submissions and representations (**Appendices 3.5 to 3.6**) on that report made by the Respondent and [Corporate Practice P], was of the opinion that the Respondent (the practising director when the first and second practice reviews were carried out) had, in his audits of one or more of the financial statements set out below, failed or neglected to observe, maintain or otherwise apply professional standards on a number of occasions. Accordingly, the PRC decided that complaints against the Respondent should be filed to the Registrar of the Institute under section 32D(5) of the PAO.

<u>Company name</u>	<u>Financial statements for the year ended</u>
(A) [Company A] and its subsidiaries (collectively the " [Company A] Group ")	31 December 2008 (" 2008 [Company A] Financial Statements ")
(B) [Company B] and its subsidiaries (collectively the " [Company B] Group ")	31 March 2009 (" 2009 [Company B] Group Financial Statements ")

Audit of the [Company A] Group

7. [Company A] is a listed company in Hong Kong (stock code: [xxxxx]). It was placed into the second stage of delisting procedures on [date]¹. [Corporate Practice P] was appointed² and resigned as the auditor of [Company A] with effect from 2 August 2007 and 14 April 2010 respectively. A copy of the 2008 [Company A] Group Financial Statements, on which [Corporate Practice P] expressed a qualified opinion on the fundamental uncertainty of the [Company A] Group to continue as a going concern is at **Appendix 2.1**. [Corporate Practice P]'s audit report dated 26 June 2009 was signed by the Respondent as the corporate practice director responsible for the performance of the audit engagement.
8. At the balance sheet date of 31 December 2008, the Group's major assets and operating results are summarised below:

	2008	% to Total	2007
	HK\$	Assets / Net	HK\$
	<u>million</u>	<u>Liabilities</u>	<u>million</u>
Property for sale – completed property	778	89% / 688%	729
Accounts receivable	75	9% / 66%	70
Others assets	<u>17</u>		<u>65</u>
Total assets	870		864
Liabilities	<u>(983)</u>		<u>(917)</u>
Net liabilities	<u>(113)</u>		<u>(53)</u>
(Loss)/Profit before taxation	<u>(70)</u>		<u>232</u>

First Complaint

9. 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 the then applicable Hong Kong Accounting Standard 21 "*The Effects of Changes in Foreign Exchange Rates*" ("**HKAS 21**") in the audit of the 2008 [Company A] Group Financial Statements, in that an exchange gain of approximately HK\$17,342,000 had been wrongly treated as income rather than as a separate component of equity in the 2008 [Company A] Group Financial Statements and the audit opinion did not contain any qualification on this.

¹ Subsequently, the Stock Exchange placed [Company A] into the third delisting stage on [date].

² Known as [another name] at the relevant time.

Second Complaint

10. 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 the then applicable Hong Kong Standard on Auditing 500 "Audit Evidence" ("**HKSA 500**") in the audit of the 2008 [Company A] Group Financial Statements, as he had failed or neglected to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion contained in the independent auditor's report on the 2008 [Company A] Group Financial Statements.

Third Complaint (Alternative to the Second Complaint)

11. 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 the then applicable Hong Kong Standard on Auditing 230 "Audit Documentation" ("**HKSA 230**") in the audit of the 2008 [Company A] Group Financial Statements, as he had failed or neglected to prepare audit documentation that provided a sufficient and appropriate record of the basis for the independent auditor's report on the 2008 [Company A] Group Financial Statements.

Fourth Complaint

12. 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. The professional standard refers to the Fundamental Principles set out in section 100.4 of the Code of Ethics for Professional Accountants (the "**Code**") and the elaboration in section 130 of the Code. In carrying out the audit of the 2008 [Company A] Group Financial Statements, The Respondent had not maintained professional knowledge and skill at the level required to ensure that the client received competent professional service.

Relevant professional standards

13. Paragraph 39 of HKAS 21 (**Appendix 5.1**) reads:

"39 The results and financial position of an entity ... shall be translated into a different presentation currency using the following procedures:

- (a) assets and liabilities for each balance sheet presented (ie including comparatives) shall be translated at the closing rate at the date of that balance sheet; ...*
- (c) all resulting exchange differences shall be recognised as a separate component of equity." (underline added)*

14. Paragraph 44 of HKAS 21 sets out that:

"Paragraphs 45 - 47, in addition to paragraphs 38 - 43 apply when the results and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation..."

15. Paragraph 2 of HKSA 500 (**Appendix 5.2**) reads:

"2. The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion."

16. Paragraph 2 of HKSA 230 (**Appendix 5.3**) reads:

"2. The auditor should prepare, on a timely basis, audit documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was performed in accordance with HKSAs and applicable legal and regulatory requirements."

17. Paragraphs 100.4(c) and 130.2 of the Code (**Appendix 5.4**) read:

"100.4 A professional accountant is required to comply with the following fundamental principles: ...

(c) Professional Competence and Due Care

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services."

"130.2 Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service...."

Facts and circumstances in support of the First and Fourth Complaints

(1) Exchange gains not recognised as a separate component of equity

18. Property for sale of HK\$778 million at the balance sheet date of 31 December 2008 (2007: HK\$729 million) represented the fair value of the Group's property located at Xicheng District, Beijing, which was transferred from the buyer of [Building X] as part of the proceeds (Note 17 to the 2008 [Company A] Group Financial Statements (page 31)). Note 17 also disclosed that the fair value of the property remained at RMB700 million at the 2007 and 2008 year end dates and arising from the translation of the Property for Sale into HK\$777,778,000 (2007: HK\$729,167,000), "... exchange gain of approximately HK\$48,611,000 at 31 December 2008 (2007: approximately HK\$18,762,000) had been credited to consolidated income statement" (underline added).
19. In fact, Note 17 was incorrect. For the reasons set out below, only an exchange gain of HK\$17,342,000 was credited to Consolidated Income Statement in the 2008 [Company A] Group Financial Statements.
20. From the information contained in the audit working papers [wp NC/2008/Audit 000352, **Appendix 4.1**], the exchange difference can be calculated as follows:

		2008	2007	<i>Difference</i>
		'000	'000	\$'000
		(C)	(D)	(C-D)
<i>Property for sale (in Beijing)</i>				
<i>At valuation (A)</i>	<i>RMB</i>	700,000	700,000	-
	<i>HK\$</i>	777,778	729,167	48,611
	=			
<i>At cost (B)</i>	<i>RMB</i>	450,273	450,273	-
	<i>HK\$</i>	500,303	469,034	31,269
	=			
<i>Fair value adjustment (A-B)</i>	<i>RMB</i>	249,727	249,727	-
	<i>HK\$</i>	277,475	260,133	17,342
	=			

The [Company A] Group translated assets and liabilities denominated in RMB into HK\$ at the closing exchange rate of HK\$1=RMB0.90 on 31 December 2008 (2007: HK\$1=RMB0.96). Since there was appreciation of RMB against HK\$ in the year of 2008, an exchange gain arose when translating RMB denominated assets into HK\$.

21. Based on the audit working papers of [Corporate Practice P] [wp NC/2008/Audit/000176-183, 186, 187 and 641, **Appendix 4.1**], exchange gain of HK\$48,611,000 arising from translating the Property for sale had not been fully credited to the exchange translation reserve (a separate component of equity), as required under paragraph 39 of HKAS 21. Instead, HK\$17,342,000 [wp NC/2008/Audit/000187] was recognised in the Consolidated Income Statement of [Company A] Group during the year, as part of the net exchange gain of HK\$15,792,000 [wp NC/2008/Audit/000641] which was grouped under

Other Revenue in 2008 [Company A] Group Financial Statements (Note 9, page 25).

(A schedule showing the reconciliation of the exchange gain of HK\$17,342,000 to Other Revenue of [Company A] Group is at **Appendix 6**)

22. Applying paragraph 39 of HKAS 21, all resulting exchange differences arising from translating the results and financial position of an entity's subsidiary in mainland China should be recognised as a separate component of equity. In the present case, the exchange differences arising on translation of assets of a foreign operation should have been shown in the Consolidated Statement of Changes in Equity in the 2008 [Company A] Group Financial Statements and should not have been credited to the Consolidated Income Statement of the [Company A] Group (page 3 of 2008 [Company A] Group Financial Statements).
23. In the above circumstances, the [Company A] Group's Loss before taxation for the year was materially understated by HK\$17,342,000 (24.8% of the Loss before taxation). The [Company A] Group's Loss before taxation for the year should have been HK\$87,163,000 (HK\$69,821,000 + HK\$17,342,000).
24. The audit documentation does not show The Respondent had assessed whether the treatment of exchange difference was in compliance with HKAS 21. The audit opinion did not contain a separate "qualified (except for disagreement) opinion" specifically in respect of the [Company A]'s failure to comply with the requirement of HKAS 21.

Facts and circumstances in support of the Second to Fourth Complaints

(2) Accounts receivable of HK\$75 million

25. Accounts receivable of HK\$75 million at the balance sheet date of 31 December 2008 represents the remaining proceeds receivable from the buyer of [Building X], a property located in Beijing, which was sold by a subsidiary of [Company A] ([Subsidiary B]) in mid 2007. Revenue from the sale transaction was recognised in 2007.
26. Note 18 to the 2008 [Company A] Group Financial Statement [page 31] disclosed that:

"Accounts receivable represents proceeds receivable from sales of [Building B]. Customers will repay according to the Sales and Purchase Agreement signed on 23 December 2003. The amount was past due but not impaired and expected to be recovered within one year." (underline added)
27. In the audit working paper [wp NC/2008/Audit/001625], concern had been raised over the recoverability of the amount due from the buyer, [Company C]. It was recorded that:

"The amount due from [Company C] couldn't be recovered in the near [future] as the legal entitlement of [Building B]³ has not been transferred to [Company C] yet. [Company C] would repay the amount when the legal entitlement is transferred to [Subsidiary B].

Per discussion with the account [staff], they stated that the requirement of [transfer] of legal entitlement is that [Subsidiary B] must [repay] all the outstanding TAX to government first. Since [Subsidiary B] has not sufficient money to repay the outstanding amount, such receivable from [Company C] wouldn't be received in the near future." (underline added)

28. To address this concern, the audit documentation shows that the audit team performed the following work:

- (1) reviewed the terms of the sale and purchase agreement between the [Company A] Group and the buyer and noted:

"In accordance with contract term of agreement (P-file AA2-1) the balance payment to [Subsidiary B] would be settled when the legal entitlement of [Building B] had been transferred. Up to 26/6/2009, the legal entitlement transferral is still in progress. Even no confirmation had been received from [Company C], the amount is still recoverable under the terms of agreement and the agreement is still effective as well" [wp NC/2008/Audit/000384]

- (2) obtained written management representation to the effect that:

"17. Regarding to accounts receivable due from [Company C] in amounting to RMB67,571,246.60 (approximately HK\$75,079,162.89, the confirmation have been sent to [Company C] during the course of the audit accordingly. No returned confirmation [has] been received. The management regard that the amount can be recovered and decide not to write off the amount" [wp NC/2008/Audit/000047 to 49]

29. Further, in [Corporate Practice P]'s letter dated 31 December 2009 (**Appendix 1.3**), it represented that:

- (1) the client's director had orally confirmed that the buyer [Company C] would settle the receivable when the title was transferred; and
- (2) it had assessed the financial status of the debtor [Company C].

³ It appears that [Building B] was the new name of the [Building X] after its disposal to [Company C] in 2007.

These were not documented in the audit working papers of [Corporate Practice P].

30. However, what the Respondent failed to adequately address was [Subsidiary B]'s ability to transfer legal title to [Company C] - a pre-requisite before [Company C] would become obliged to pay the outstanding account receivable of HK\$75 million.
31. Under the terms of the Agreement on Transfer of Land Use Right dated 30 November 1999 (the "**Agreement**") [w/p NC/2007/P/00778-787, **Appendix 4.2**], [Subsidiary B] had to first settle all outstanding land premiums and penalties due to the relevant government authority before it could transfer the legal title in the land use right (and the building erected on the land, ie [Building X]) to any other party.
32. As at year ended 31 December 2008, the outstanding land premium and penalties for the [Building X] property stood at HK\$114 million [wp NC/2008/Audit/000419], which was grouped under Trade Payables in the balance sheet (Note 21 to the 2008 Financial Statements).
33. As stated clearly in the Agreement, the legal entitlement of the land cannot be transferred to any other party unless all land premium and penalty charges are settled. The Agreement also stated that the Land Bureau has the right to void the Agreement and ask for damages if [Subsidiary B] default on settlement of the land premium [w/p NC/2007/P/00781-782]. The Respondent should have noted that the disclosures in the Financial Statements that the amount was 'past due' and 'to be recovered within one year' were not correct.
34. When auditing the 2008 [Company A] Group Financial Statements, an experienced auditor would be expected to consider whether appropriate disclosures had been made in the financial statements in determining whether a qualified audit opinion should be expressed. There is no audit evidence available to suggest that [Corporate Practice P] had made any such considerations.

(3) **Going concern assessment**

35. [Corporate Practice P] qualified its audit opinion on the going concern basis adopted by the management of [Company A] Group for preparing the 2008 [Company A] Group Financial Statements:

"Qualified opinion arising from fundamental uncertainty to continue as a going concern"

In our opinion, except for fundamental uncertainties relating to the going concern basis, the financial statements given a true and fair view of the statement of affairs of the Group as at 31 December 2008 and of the Group's loss and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have

been properly prepared in accordance with the disclosure requirements of Hong Kong Companies Ordinance."

36. The audit work on going concern assessment performed by [Corporate Practice P] recorded in audit working papers [wp NC/2008/Audit/000712-753] is summarised below:

- (i) completion of checklist for going concern assessment [wp NC/2008/Audit/000728, 730-731];
- (ii) obtained from the [Company A] Group a proposed loan rescheduling plan with a major creditor. It was proposed that the [Company A] Group repay to the creditor all the outstanding loans and interests thereon by 31 March 2010;
- (iii) sent a letter to the major creditor to confirm the legal proceedings taken by the creditor against the [Company A] Group and the outstanding balance owed by the [Company A] Group to the creditor; and
- (iv) obtained from the [Company A] Group a cash flow projection [wp NC/2008/Audit/000732]. The cash inflows were mainly from [Company O], a company that the [Company A] Group planned to acquire.

37. [Corporate Practice P] also obtained the following representations from management:

"In order to ascertain the going concern basis, the management has taken the following actions in order to ensure that the Group will be able to finance its future working capital and financial and requirements:

- *The Group has been actively discussing with a third party to arrange a financing activity to obtain a new working capital; and*
- *The group has been actively negotiating with a party in relation to a possible property development project.*

To prove the Group will be able to operate on going concern basis, a eighteen months period cash flow projection and profit forecasting of the Group was attached ... for [Corporate Practice P's] review" [wp NC/2008/Audit/000049]

In an audit working paper [wp NC/2008/Audit/000732], it was recorded that:

"The cash flow projection is based on the cash flow projection of [Company A] and [Company O] within coming 18 months. Based on the result on the cash flow projection, the [Company A] would have sufficient capital to operate as going concern. However, the project acquisition is not completed at the moment. We considered that the [Company A] may not [have] sufficient capital to operate as

going concern. Therefore, the qualified opinion on going concern is formed."

38. The information available suggests that there were events and conditions which might cast significant doubt on [Company A]'s ability to continue as a going concern:

(1) The financial position of the [Company A] Group had worsened in 2008

- the Group had not reported any turnover as there was no revenue from sale of properties during the year;
- the Group incurred a loss for the year of HK\$70 million. In addition, total liabilities of HK\$982.6 million exceeded total assets of \$869.5 million by \$113 million.

(2) a major creditor of the [Company A] Group ([Company S]) initiated legal proceedings against [Company A] to claim for a loan together with interests thereon amounting to HK\$58 million (Note 31(c) to 2008 [Company A] Group Financial Statements); and

(3) the [Company A] Group did not settle operating expenses such as office rental in Beijing (HK\$4.1 million) and consultancy fees payable to a third party (HK\$5.7 million) [wp NC000426].

39. The Hong Kong Standard on Auditing 570 "Going Concern" ("**HKSA 570**") (**Appendix 5.6**) provides:

"26. When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

- (a) **Review management's plans for future actions ...**
- (b) **Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and..."**

"33....In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion

"34. If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate....

"35. If, in the auditor's judgment, the entity will not be able to continue as a going concern, the auditor should express an adverse opinion ..."

40. An experienced auditor would have taken into account the additional matters set out above and considered whether the "except for" qualified opinion in the auditor's report would be sufficient to address the [Company A] Group's difficulties to continue as a going concern. There was insufficient documentation in the audit file of [Corporate Practice P] to support its "except for" qualified opinion on the 2008 [Company A] Group Financial Statements.

Audit of the [Company B] Group

41. [Company B] is a listed company in Hong Kong (stock code: [xxxxx]). [Corporate Practice P] was appointed as [Company B]'s auditor on 24 April 2009, and still is the company's appointed auditor.

A copy of the 2009 [Company B] Group Financial Statements, on which [Corporate Practice P] expressed a clean opinion, is at **Appendix 2.2**. [Corporate Practice P]'s audit report, dated 26 June 2009, was also signed by The Respondent as the corporate practice's director responsible for the performance of the audit engagement.

42. During the year ended 31 March 2009, the [Company B] Group acquired a group of companies which were engaged in gold exploration, mining and minerals processing in the People's Republic of China.
43. At the balance sheet date of 31 March 2009, the major assets and operating results of the [Company B] Group are summarised below:

	<u>HK\$</u>	<u>% to Total / Net assets</u>
Intangible assets:-	<u>million</u>	
Goodwill	1,408	86% / 150%
Exploration and evaluation assets	103	6% / 11%
Prepayments for exploration and evaluation assets and mining rights	48	3% / 5%
Others	<u>71</u>	
Total assets	<u>1,630</u>	
Liabilities	<u>(691)</u>	
Net assets	<u>939</u>	
(Loss) for the year	<u>(95)</u>	

Fifth Complaint

44. 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 the then applicable HKSA 500 in the audit of the 2009 [Company B] Group Financial Statements, as he had failed or neglected to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion contained in the independent auditor's report on the 2009 [Company B] Group Financial Statements.

Sixth Complaint (Alternative to the Fifth Complaint)

45. 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 the then applicable HKSA 230 in the audit of the 2009 [Company B] Group Financial Statements, as he had failed or neglected to prepare audit documentation that provided a sufficient and appropriate record of the basis for the independent auditor's report on the 2009 [Company B] Group Financial Statements, or that he failed or neglected to prepare audit documentation that enabled an experienced auditor to understand the results of the audit procedures and the audit evidence obtained.

Seventh Complaint

46. 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. The professional standard refers to the Fundamental Principles set out in section 100.4 of the Code and the elaboration in section 130 of the Code. In carrying out the audit of the 2009 [Company B] Group Financial Statements, The Respondent had not maintained professional knowledge and skill at the level required to ensure that the client received competent professional service.

Relevant professional standards

47. In addition to the professional standards stated in paragraphs 15 to 17 above (paragraph 2 of HKSA 500, paragraph 2 of HKSA 230, and paragraphs 100.4(c) and 130.2 of the Code), paragraph 9 of HKSA 230 (**Appendix 5.3**) is also relevant. It reads:

"9. The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:...

(b) The results of the audit procedures and the audit evidence obtained; and..."

Facts and circumstances in support of the Fifth to Seventh Complaints

(4) Goodwill arising from acquisition of a subsidiary of HK\$1,408 million

48. Note 34 to the 2009 [Company B] Group Financial Statements (pages 84) disclosed that the [Company B] Group acquired the entire issued share capital of [Subsidiary M] during the year ended 31 March 2009:

	<u>HK\$ million</u>	<u>HK\$ million</u>
Consideration		1,390.8
Less: " <u>Carrying amounts</u> " and " <u>fair values</u> " of the acquired (liabilities) – included intangible assets of HK\$107 million	(9.6)	
Minority interest	<u>(5.1)</u>	
Fair value of the acquired liabilities		<u>14.7</u>
Goodwill		<u>1,405.5</u>

49. Note 34 further disclosed that:

"Goodwill arose in the business combinations because the cost of the combinations effectively included amounts in relation to the benefit of expected synergies, revenue growth, further market development and the assembled workforce of [Subsidiary M] Group. These benefits are not recognised separately from goodwill as the future economic benefits arising from them cannot be reliably measured."

50. Working papers [wp G001037 to G001052; and G002648 to G002907, **Appendix 4.4**] recorded that the audit work performed on the assets and liabilities on [Subsidiary M] Group as at 30 April 2008, the date of acquisition, included the review of consolidation work sheets and the related adjustments; and checking of contracts for construction works, receipts issued by receivers of payments and statements for construction works etc.
51. Apparently, all the assets and liabilities of [Subsidiary M] Group were stated at carrying amounts, except for the intangible assets of HK\$107.9 million, which included a re-valued asset, the valuation (as of October 2007) of which was performed in March 2008 ([Y mining shaft], see paragraph 61 below).
52. The then effective Hong Kong Financial Reporting Standard 3 "Business Combinations" ("**HKFRS 3**") (**Appendix 5.7**) provided that:

"36 The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at that date, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, which

shall be recognised at fair value less costs to sell. Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities so recognised shall be accounted for in accordance with paragraphs 51-57." (underline added)

53. The working papers contained no documentation of the work performed to ensure that the [Company B] Group had recognised, in accordance with HKFRS 3, the fair values of [Subsidiary M] Group's identifiable assets, liabilities and contingent liabilities as at the acquisition date (ie 30 April 2008). Consequentially, there is insufficient audit evidence that the goodwill arising from the business combination, being the difference between the cost of the business combination and the [Company B] Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of [Subsidiary M] Group, would not be misstated.

(5) Impairment assessment of goodwill of HK\$1,408 million

54. Note 16 to the 2009 [Company B] Group Financial Statements (page 67) disclosed:

"Impairment testing of goodwill

The goodwill relates to the excess of consideration paid and the fair value of net assets acquired from the acquisition of [Subsidiary M Group]. For the purpose of impairment testing, the recoverable amount of the cash-generating unit of the [Subsidiary M] Group has been determined based on a value in use calculation using cash flow projection based on financial budget covering the estimated mine lives, and approved by senior management."

The note also disclosed the key assumptions used in the value in use calculation.

55. The then effective Hong Kong Accounting Standard 36 "Impairment of Assets" ("HKAS 36") (Appendix 5.8) provided that:

"33 *In measuring value in use an entity shall:*

(a) base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence...." (underline added)

56. The only information found in [Corporate Practice P]'s working papers that would be relevant to an impairment test are :

(a) Cashflow forecast of the [Company B] Group from April 2009 to September 2010 [wp G000927] and explanatory notes [wp G000928]; and

(b) Documents titled "[Mine T] Production" from March 2010 to March 2022 [wp G000929 and G000930] and explanatory notes [wp G000931], assumptions used for the cashflow projection [wp G000932], information on cost of debts [wp G000933] and information on gold price [wp G000934 to G000939]. "[Mine T] Production" apparently showed the calculation of discounted cash flow of the gold mining business of the [Company B] Group for 13 years from March 2010 to March 2022.

57. However, there was no documentation in [Corporate Practice P]'s working papers on how the information mentioned in paragraph 56 above was used for assessing the impairment test carried out by the management of the [Company B] Group. At the very least a comparison between the carrying value of a cash generating unit (in this case, the goodwill of HK\$1.4 billion and exploration and evaluation assets of HK\$103 million) to its value in use would have been expected.

58. It is also not clear from [Corporate Practice P]'s working papers what audit procedures were performed in assessing the discounted cashflow based on "[Mine T] Production" (paragraph 54(b)), for example, it is not clear in the working papers of [Corporate Practice P] whether it had assessed:

- the assumptions used for the cashflow projection [wp G000932];
- the reasonableness of the expenditures to be incurred over the 13 years
- the reasonableness of the selling price of [Company B] Group's products
- the reasonableness of the discount rate used to discount the cashflow
- the reasonableness of the 13-year period adopted by the management

59. HKAS 36 also provided that:

"44. Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:...

(b) improving or enhancing the asset's performance."

60. Based on working paper [wp G000931], the management of the [Company B] Group apparently assumed an increase of daily production by making further capital investments. There is no documentation of whether the Respondent had assessed that the management's assumption had nevertheless met the requirements of paragraph 44 of HKAS 36.

(6) Exploration and evaluation assets of HK\$103 million

61. Note 16 to the 2009 [Company B] Group Financial Statements disclosed that exploration and evaluation assets of HK\$103 million were grouped under intangible assets.
62. Note 3(i) to the 2009 [Company B] Group Financial Statements disclosed that "Exploration and evaluation assets which include exploration and development cost are stated at cost less accumulated amortisation and impairment losses" and "... costs capitalised are amortised using the units of production method..."
63. Working paper [wp G001689] documented the following work performed and conclusion made by [Corporate Practice P]:

"Findings:

There was a valuation report relating to the PD69 [Y mining shaft] appreciated value RMB4,380,000 [wp G001793] as at 31 October 2007, refer to [wp G001786 to G001796] <valuation report>

Notes:

- *Prepare the summary of intangible assets, refer to [wp G001690]*
- *Perform the transaction test, fully check, refer to [wp G001691 to G001784]*
- *Prepare the register of intangible assets, refer to [wp G001785]*

Conclusions:

- *The results are satisfactory, and the balance is fairly stated."*

64. The exploration and evaluation assets of HK\$103 million comprised RMB86,951,150 [wp G001689] and an adjustment of RMB4,103,790 for appreciation of the above mentioned mining shaft to RMB4,380,000 [wp G001023, G001016 and G001017]. Based on the "register of intangible assets" [wp G001785], RMB86,951,150 represented the net amount of costs of, apparently, various mining infrastructures (warehouses, mining shafts etc) after amortisation (over 12 years after deducting residual value of 3%).
65. It is noted that the audit work "transaction test, fully check" [wp G001691 to G001784] was checking of accounting vouchers, bank payment slips and statements for construction works etc which dated between 2008 and 2009. However, a majority of the mining infrastructures, based on the "register of intangible assets" [wp G001785], were injected by the original shareholders (of the mainland subsidiary which operated gold mining) in 2005. There was also no documentation of the type of activities that incurred the expenditures.

66. According to the then effective Hong Kong Financial Reporting Standard 6 "Exploration for and Evaluation of Mineral Resources" ("**HKFRS 6**") (**Appendix 5.9**), examples of expenditures that might be included in the initial measurement of exploration and evaluation assets are costs incurred for acquisition of rights to explore; topographical, geological, geochemical and geophysical studies; exploratory drilling; trenching; sampling; and activities in relation to evaluation the technical feasibility and commercial viability of extracting a mineral resource.
67. Paragraph 5 of HKFRS 6 provided that expenditures incurred (a) before the exploration for and evaluation of mineral resources; or (b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable, shall not be recognised as exploration and evaluation assets. Accordingly, the expenditures should be accounted for differently according to the type of activities that incurred the expenditures, e.g.:
- before the exploration for and evaluation of mineral resources – to be charged to income statement;
 - for exploration for and evaluation of mineral resources – to be recognised as exploration and evaluation assets;
 - after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable – to be recognised according to the nature of the assets, e.g. mining infrastructure according to Hong Kong Accounting Standard 16 "Property, Plant and Equipment" ("**HKAS 16**") (**Appendix 5.10**); or mining rights according to Hong Kong Accounting Standard 38 "Intangible Assets" ("**HKAS 38**") (**Appendix 5.11**); or
 - related to the development of mineral resources – to be accounted for according to HKAS 38.
68. Since there was insufficient information contained in the working papers, whether or not the exploration and evaluation assets of HK\$103 million had been correctly accounted for cannot be ascertained and therefore, there could be significant impact on the 2009 [Company B] Group Financial Statements. Possible impacts are:
- expenditures relating to mining infrastructures should have been recognised as fixed assets and stated at costs less depreciation and impairment according to HKAS 16
 - expenditures relating to mining rights should have been recognised as intangible assets and stated at costs less amortisation and impairment according to HKAS 38
 - exploration and evaluation assets should have been stated at costs less impairment according to HKFRS 6

(7) Prepayments for exploration and evaluation assets and mining rights of HK\$48 million

69. Prepayments for exploration and evaluation assets and mining rights of HK\$48 million were shown as current assets in the Consolidated Balance Sheet (page 27 of 2009 [Company B] Group Financial Statements).
70. Working papers [wp G001797, G001016 and G001017] show that HK\$48 million comprised RMB29.2 million paid for exploration and mining rights and RMB13.5 million for exploration expenses (地質勘查費). The working paper [wp G001797] documented the following comments and conclusion made by [Corporate Practice P]:

" # Exploration and mining rights [RMB29.2 million] as consideration of RMB20 million were transferred from Luonan and the remaining balance of RMB8.5 million was paid during the year Amount paid of RMB20 million was matched to the contract.

** Such amount [RMB13.5 million] was not matched to the contract, because the amount paid is based on the actual stage of production.*

Notes:

- Perform the transaction test on prepayments for exploration and evaluation assets and mining rights, refer to [wp G001811]*

Conclusions:

- The test is satisfactory and the balance is fairly stated"*

71. It was noted that the "transaction test" referred by [Corporate Practice P] was the checking of bank payment slips, receipts issued by receivers of payments and statements for construction works etc for the period between 2008 and 2009 [wp G001812 to G001834] with a total amount of RMB16.6 million [wp G001811] and covering payments for both exploration and mining rights and exploration expenditures.
72. The working paper [wp G001631] also listed out 3 mining licences and 5 exploration permits of the [Company B] Group as at 5 November 2007. Among the 5 exploration permits, 2 permits appear to be newly acquired with legal title not yet passed to the [Company B] Group; and 1 acquired permit was subsequently cancelled. However, there is no clear linkage between the information contained in this working paper to other working papers to enable another auditor to understand where those assets were booked by the [Company B] Group - e.g. working paper on prepayments for exploration and evaluation assets and mining rights [wp G001797] and working paper on exploration and evaluation assets [wp G001689].

73. Prepayments for exploration and mining rights of RMB29.2 million were recorded by the [Company B] Group. However, the documentation only stated that one exploration permit and one mining licence were purchased at RMB16 million and RMB4 million respectively. Hence, the amount of RMB29.2 million apparently exceeded the contracted sums of RMB20 million. There was no explanation for the difference.
74. Further, there was no documentation of whether or not ownership of the permits and licences were obtained. The working papers [wp G001631] refer to a newly purchased exploration permit at Luonan and state that "*full consideration paid, title not yet passed (全付, 未過戶)*". Had the ownership been obtained, the costs of the permits and licences should no longer be recorded as prepayments and proper reclassification should have been made and the accounting treatment for the assets would be different from that for prepayments. No analysis appears to have been carried out to determine the proper treatment of this asset.
75. As regards the exploration expenditures, there was no documentation of the type of activities that incurred the expenditures and therefore, the correct accounting treatment cannot be ascertained (see the issue highlighted in paragraph 66 above).

(8) Going concern assessment

76. The group had net current liabilities of HK\$13.8 million as at 31 March 2009 (page 27 of Appendix 2.2). It incurred losses of HK\$95 million and HK\$11.6 million respectively in the years ended 31 March 2009 and 2008 (page 26 of Appendix 2.2). These are indicators suggesting that the Group might have a going concern problem.
77. HKSA 570 provides that:
 - "9. The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements...."
78. [Corporate Practice P] obtained an 18-month cashflow forecast for the period ended September 2010 for the [Company B] Group [wp G000927] and explanatory notes [wp G000928].
79. However, there was no documentation in [Corporate Practice P]'s working papers on how it assessed that the going concern assumption adopted by the management of the [Company B] Group was valid.

80. The cashflow forecast indicated a net cash inflow of HK\$9 million for the 12-month period ended 31 March 2010 and a net cash inflow of HK\$41 million for the 6-month period ended 30 September 2010.
81. Note 28 to the 2009 [Company B] Group Financial Statements (page 77) disclosed that "Promissory Note A" amounting to HK\$60 million was issued by the [Company B] Group as part of the consideration for acquisition of the [Subsidiary M] Group, and that it had a fixed term of 18 months from the date of issue of 30 April 2008. However, the cashflow forecast apparently did not take into consideration that the Promissory Note A would have to be settled in October 2009.
82. Paragraph 12 of HKSA 500 (**Appendix 5.2**) reads:
- "12. ...when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional audit procedures are necessary to resolve the inconsistency."
83. The [Company B] Group apparently did not have sufficient cash inflows to meet its fund requirement in the coming 12 months. An experienced auditor would have obtained more evidence from the management to support the going concern assumption had been correctly adopted.
84. The Respondent admitted the Complaint against him. He did not dispute the facts and matters as set out in the Complaint. The Disciplinary Committee (the "DC") is satisfied by the documentary evidence adduced by the Complainant and the admission by the Respondent of the facts and matters in the Complaint that the First, Second, Fourth, Fifth and Seventh Complaints of the Complainant are proved. The parties agreed that the steps set out in paragraphs 17 to 30 of the Disciplinary Committee Proceedings Rules be dispensed with.
85. By 2 letters dated 25 October 2011 and 12 January 2012 addressed to the Complainant and the Respondent, the Clerk to the DC, under the direction of the DC, informed the parties that they should make written submissions to the DC as to the sanctions and costs and that the DC would not hold a hearing on sanctions and costs unless otherwise requested by the parties.
86. The DC has duly and carefully considered the written submissions of both the Complainant (of 15 November 2011 and 2 February 2012 respectively) and the Respondent (of 10 November 2011 and 1 February 2012 respectively).
87. In arriving at the proper sanctions to be imposed on the Respondent, the DC has had regard to the following facts and matters specific to this case:
- (1) The 8 audit deficiencies identified in the Complaint not only demonstrates mere slips or misjudgement but a serious incompetence on the part of the Respondent. The Respondent acknowledged his incompetence but attributed it to the more demanding nature of the audit of listed companies. He also

admitted that he lacked the required man power to cope with the audit of listed companies. Yet the Respondent was prepared to take up audit for listed companies when he himself was incompetent to handle the work and he was not assisted by any competent staff. It is true that audit of listed companies may be more complex. However, the 8 audit deficiencies identified by the Complainant raises serious doubts about the competence of the Respondent to marshal even the audit fundamentals expected of him as a professional auditor. For example, in the 2008 [Company A] Group Financial Statements, the loss of the [Company A] Group was materially understated by more than HK\$17 million representing 24.8% of the reported loss. Such audit deficiency alone has significantly impaired the integrity of the audit opinion. It is for these reasons that the DC considers that this is a serious case and deterrence should be its prime concern in deciding the proper sanction of the Respondent.

- (2) The Complaint concerns 2 audit clients which were public listed companies, the shares of one of which were and still are traded on the stock exchange. In all fairness to the Respondent it must be mentioned that the trading of the shares of the other listed company had been suspended for about 6 years before the relevant audit and that at the time of the audit, it was in its 2nd stage of delisting. Further, the DC is not aware of any one coming forward with a claim for damages as a result of the Respondent's transgression. Nevertheless, the DC does not lose sight of the need to safeguard the public interest which is often unmeasured in money terms.
- (3) The Respondent has failed to address the audit deficiencies despite an earlier Practice Review. In the PRC 1st Reviewer's Report, the Respondent had been informed of the findings of audit deficiencies in respect of the audit for listed client [Company A] for year 2007 such as absence of thorough assessment and inadequate audit evidence for a going concern opinion. In a subsequent supplemental report of 13 September 2010, the same deficiencies such as inadequate audit evidence for [Company B] Group still featured. It seems that the Respondent did not properly take on board the advice or guidance of the PRC to address the deficiencies, and even at one stage sought to challenge some of the PRC's findings.
- (4) A removal from the register, even temporary, may stifle the livelihood of the Respondent. On the other hand, members of the public are entitled to expect a member of the Institute to be able to deliver the requisite skills and competence in his professional work. Public's confidence in the profession as a whole must be maintained and restored.
- (5) The Respondent has shown remorse by admitting to the Complaint. He has admitted the Complaint at the early stage and he also promptly ceased the audit for the 2 listed companies in question.
- (6) There is no evidence showing that in carrying out the audit work, which is the subject matter of the Complaint, the Respondent was dishonest in any aspect.

88. In considering the proper order to be made in this case, the DC has had regard to all the aforesaid matters, including the particulars of breaches, the Respondent's personal circumstances, and the conduct of the Complainant and the Respondent throughout the proceedings.

89. Consequently, the DC orders that:-

- (1) the practising certificate issued to the Respondent for year 2012 be cancelled 40 days after the date hereof under Section 35(1)(da) of the PAO;
- (2) a practising certificate shall not be issued to the Respondent for 2 years next following the calendar year of this Order under section 35(1)(db) of the PAO;
- (3) the Respondent do pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$68,145 under Section 35(1)(iii) of the PAO.

Dated the 8th day of October 2012