

IN THE MATTER OF

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

BETWEEN

The Registrar of the Hong Kong Institute of Certified Public Accountants

COMPLAINANT

AND

1st Respondent

FIRST
RESPONDENT

2nd Respondent

SECOND
RESPONDENT

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

Members:

REASONS FOR DECISION

1. This is a complaint made by the Registrar of the Hong Kong Institute of Certified Public Accountants (the “**Institute**”) against on the 1st Respondent, a certified public accountant (practising) and the 2nd Respondent, a corporate practice as the Respondents. Section 34(1)(a)(vi) of the PAO applied to the Respondents.
2. The particulars of the Amended Complaint agreed by the parties on 23 April 2014 (the “**Amended Complaint**”), are as follows:-

Background

- (1) Company A (the “**Company**”) is incorporated in the Cayman Islands and its shares are listed on the Main Board (Stock Code xxxx) of the Stock Exchange of Hong Kong (the “**Stock Exchange**”).
- (2) The Company held a 29.9% equity interest in Company B, a company domiciled in the United Kingdom and whose shares were listed on the Alternative Investment Market of the London Stock Exchange.
- (3) On 11 September 2009, the Company issued a circular dated 14 September 2009 (the “**Circular**”) to report its conditional offer to acquire a further 64.1% issued capital of Company B (the “**Acquisition**”). The Acquisition was completed on 12 October 2009.
- (4) On 26 February 2010, the Company published a supplemental circular (the “**Supplemental Circular**”) to provide information required pursuant to Rule 14.69 of the Listing Rules which had not been included in the Circular.
- (5) The Supplemental Circular contained a report on the unaudited pro forma financial information (“**UPFI**”) issued by the 2nd Respondent for the enlarged group of the Company and its subsidiaries (the “**Group**”) and the acquired company, Company B, and its subsidiaries (“**B Group**”). The 1st Respondent a practising director of the 2nd Respondent was responsible for the engagement.
- (6) The UPFI was prepared for illustrative purposes only. It was stated in the report on the UPFI that due to its hypothetical nature, the UPFI did not provide any assurance or indication that any event would take place in the future and might not be indicative of the financial position, financial results and cash flows of the enlarged group had the Acquisition actually occurred .
- (7) It was stated in the report on the UPFI that the 2nd Respondent's work did not involve independent examination of any of the underlying financial information but consisted primarily of comparing the unadjusted financial information with source documents, considering the evidence supporting the adjustments and discussing the UPFI with the directors of the Company.
- (8) Based on the above work, the 2nd Respondent stated in the report on the UPFI that:

“In our opinion:

- a. the Unaudited Pro Forma Financial Information has been properly compiled by the directors of the Company on the basis stated;*
- b. such basis is consistent with the accounting policies of the Group; and*
- c. the adjustments are appropriate for the purposes of the Unaudited Pro Forma Financial Information as disclosed pursuant to paragraph 4.29(1) of the Listing Rules. ”*

- (9) The Company's audited financial statements for the 15 months ended 30 June 2010 (the “**2010 Audited Financial Statements**”) (the auditors' report was signed off on 26 October 2010), recognised a deferred tax liability in the amount of HK\$238.7 million.
- (10) On 22 June 2012, the Stock Exchange referred a complaint to the Institute pursuant to section 23(8) of the Securities and Futures Ordinance (Cap 571). The Stock Exchange was concerned that no deferred tax liability arising from the Acquisition had been recognised in the UPFI.
- (11) The Stock Exchange considered that the Respondents might not have observed Hong Kong Standard on Investment Circular Reporting Engagements 300 “Accountants Reports on Pro Forma Financial Information in Investment Circulars” with reference to Accounting Guideline 7, given the lack of recognition of deferred tax liability arising from the Acquisition in the UPFI and the Respondents' failure to raise any concern in this regard in the report on the UPFI.

The Relevant Professional Standards

- (12) Hong Kong Standard on Investment Circular Reporting Engagements 300 “Accountants' Reports on Pro Forma Financial Information in Investment Circulars” (“**HKSIR 300**”) states:
- “...
4. Reporting accountants plan and perform their work so as to obtain sufficient evidence to provide reasonable assurance that:
 ...
d. the pro forma financial information has been properly compiled by the directors of the issuer on the basis stated;
e. such basis is consistent with the accounting policies of the issuer,
f. the adjustments are appropriate for the purposes of the pro forma financial information as disclosed pursuant to Listing Rule 4.29(1)/GEM Rule 7.31(1).
 ...
6. Listing Rule 4.29(1)/GEM Rule 7.31(1) requires that the pro forma financial information presented must not be misleading. In the event that the reporting accountants have reasons to believe that the pro forma financial information is misleading... they are unable to give the opinion as required in paragraph 58 below until they have resolved the matter. AG 7 provides guidance on judging whether pro forma financial information is misleading.
 ... ”
- (13) Accounting Guideline 7 “Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars” (“**AG 7**”) states:
- “ ...

8. Listing Rule 4.29(1)/GEM Rule 7.31(1) requires that the pro forma financial information must provide investors with information about the impact of the transaction ... The pro forma financial information presented must not be misleading, must assist investors in analysing future prospects of the issuer and must include all appropriate adjustments permitted ...
... ”

The Complaint

- (14) Section 34(1)(a)(vi) of the PAO applies to the Respondents in that they failed to observe, maintain or apply HKSIR 300 in expressing an unqualified opinion in their report on the UPFI as a result of having failed to identify that the Company had not applied its deferred taxation accounting policy consistently in the pro forma adjustments in the UPFI.

Facts and Circumstances in support of the Complaint

- (15) The 2nd Respondent expressed an unqualified opinion on the UPFI as set out in Appendix III "Report on Unaudited Pro Forma Financial Information on the Enlarged Group" of the Supplemental Circular in the terms reproduced in paragraph 8 above.
- (16) In section (A) of the UPFI, it is stated that the unaudited pro forma consolidated balance sheet, income statement and cash flow statement of the enlarged group were prepared based on the audited consolidated balance sheet, income statement and cash flow statement of the Group as at 31 March 2009 as published in its annual report and that of B Group as at 31 August 2009 as set out in Appendix II "Accountants' Report on Company B" of the Supplemental Circular', after making pro forma adjustments as set out in notes of the UPFI.
- (17) It is clear that the accounting policy of both the Group and B Group would recognise deferred tax:
- a. Note (3)(q)(ii) of Appendix III "Financial Information on the Group" of the Circular sets out that "... *Deferred tax liabilities are generally recognized for all taxable temporary differences ... Such assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit... Deferred tax liabilities are recognized for taxable temporary differences arising on investments in subsidiaries...*";
- (18) Note 4(f) of Appendix II "Accountants' Report on Company B" of the Supplemental Circular sets out that "...*Deferred tax is provided on temporary*

differences between carrying amounts of assets and liabilities for financial reporting purposes..."

- (19) Paragraph 15 of Hong Kong Accounting Standard 12 "Income Taxes" ("**HKAS 12**") requires that "A deferred tax liability shall be recognised for all taxable temporary differences ..." Paragraph 19 of HKAS 12 also provides that "... *For example, when the carrying amount of an asset is increased to a fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill ...*"
- (20) However deferred tax liabilities were not included in the UPFI, notwithstanding there were pro forma adjustments that concern fair value adjustments to the assets of Company B acquired (intangible assets and property, plant and equipment), cash consideration paid and the resulting goodwill. It is noted that deferred tax liabilities in the amount of HK\$238.7 million (arising from the fair value adjustments of the same nature) were recognized in the 2010 Audited Financial Statements.
- (21) In preparing their report on the UPFI, the Respondents were required to observe paragraph 4 of HKSIR 300 and obtain sufficient evidence to provide them with reasonable assurance that inter alia the UPFI had been properly compiled by the directors of the Company on the basis stated, and that such basis was consistent with the accounting policies of the Company.
- (22) In their written response to inquiries from the Institute dated 15 August 2012, the Respondents acknowledged that they had overlooked the issue of whether provision for deferred tax liability arising from the Acquisition should have been made by the directors of the Company in their preparation of the UPFI
- (23) By failing to recognise deferred tax in the UPFI of HK\$238.7 million, goodwill arising from the Acquisition had been significantly understated in the UPFI by about HK\$224.4 million (HK\$238.7 million based upon a 94% shareholding), which was significant to the total assets and net assets of the enlarged group of HK\$952.5 million and HK\$189.4 million, in the UPFI respectively:

	PFI (A)	2010 Financial Statements (B)	Variance (C) = (B)- (A)
	HK\$'000	HK\$'000	HK\$'000
Consideration (V)	668,725	938,391	
Cash	668,725	641,893	
Fair value of equity interest previously held	Nil	296,498	
Fair value of net assets acquired (W)	879,232	527,898	
Carrying value of B Group's net assets	(95,193)	(85,869)	
Fair value adjustments:			
- Intangible and fixed assets	974,425	852,454	
- <i>Deferred taxation</i>	<i>Nil</i>	<i>(238,687)</i>	<i>(238,687)</i>
Fair value shared by the Company (X) = (W)*(Y)	563,588	496,259	
- @64.1% (Y) controlling interest acquired in the Acquisition	563,588		
- @94% (Y) accumulative controlling interest acquired up to the Acquisition		496,259	
Goodwill (Z) = (V) – (X)	105,137	442,132	336,995
Total assets (Sum of non-current and current assets)	952,549	1,243,235	
Net assets	189,370	339,605	

- (24) In the circumstances, the Respondents failed to observe, maintain or apply HKSIR 300 having failed to identify that the Company had not applied its deferred taxation accounting policy consistently in the pro forma adjustments in the UPFI, which failure led to a significant understatement of goodwill such that it rendered the UPFI misleading.

3. On 20 May 2014, the parties made a joint application to the Disciplinary Committee to amend the complaint. They acknowledge that there is no change in the substance of the Amended Complaint as the fact remained similar and the difference is that it is more clearly set out in the facts and circumstances that the relevant work performed by the Respondents was not an audit of financial statements. The parties also agreed that the steps set out in paragraphs 17 to 30 of the Disciplinary Committee Proceedings Rules be dispensed with. The Respondents admitted the Amended Complaint against them.
4. On 18 June 2014, the Disciplinary Committee requested the parties that they should make written submissions on sanctions and costs. The Committee directed on 7 August 2014 that it accepted the parties' joint application to:
 - (a) amend the complaint; and
 - (b) dispense with the steps set out in Rule 17 to 30 in light of the Respondents' admission of the Amended Complaint.
5. The Committee noted the following submissions from the Complainant and the Respondents:
 - (1) The need to provide for deferred taxation was identified and rectified by the Respondents in the following audit of the Company's financial statements
 - (2) The Respondents have taken steps to avoid future occurrence of the same or similar inadvertence.
 - (3) The Respondents have a clear disciplinary record.
 - (4) There is no evidence of any member of the public suffering from any loss or damage as a result of the understatement of the goodwill of the Company in the UPFI.
6. In considering the proper order to be made in this case, the Committee has had regard to all the aforesaid matters, including the particulars in support of the Complaint, the Respondents' circumstances, and the conduct of the parties throughout the proceedings.

7. The Disciplinary Committee ORDERS that:-

- (1) the First and Second Respondent be reprimanded under Section 35(1)(b) of the PAO;
- (2) the First and Second Respondent pay a penalty of HK\$30,000 under Section 35(1)(c) of the PAO;
- (3) the First and Second Respondent do pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$25,080 under Section 35(1)(iii) of the PAO.

Dated the 26th day of September 2014

IN THE MATTER OF

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

BETWEEN

The Registrar of the Hong Kong Institute of Certified Public Accountants

COMPLAINANT

AND

1st Respondent

FIRST
RESPONDENT

2nd Respondent

SECOND
RESPONDENT

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

Members:

ORDER

Upon reading the complaint against on the 1st Respondent, a certified public accountant (practising), and the 2nd Respondent, a Corporate Practice, as set out in a the Amended Complaint 23 April 2014 agreed by the parties, the written submissions of the Complainant and Respondents dated 11 and 12 August 2014 respectively and the relevant documents, the Disciplinary Committee is satisfied by the documentary evidence adduced before it that the following Complaint is proved:

Section 34(1)(a)(vi) of the PAO applies to the Respondents in that they failed to observe, maintain or apply HKSIR 300 in expressing an unqualified opinion in their report on the unaudited pro forma financial information as a result of having failed to identify that Company A had not applied its deferred taxation accounting policy consistently in the pro forma adjustments in the unaudited pro forma financial information.

The Disciplinary Committee ORDERS that:-

1. the First and Second Respondent be reprimanded under Section 35(1)(b) of the PAO;
2. the First and Second Respondent pay a penalty of HK\$30,000 under Section 35(1)(c) of the PAO;
3. the First and Second Respondent do pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$25,080 under Section 35(1)(iii) of the PAO.

Dated the 26th day of September 2014