

DECISION

Proceedings No: D-18-1430F

IN THE MATTER OF

A Complaint made and referred under sections 34(1), 34(1A) and 34(1AA) of the Professional Accountants Ordinance Cap. 50

Between

THE REGISTRAR OF THE HONG
KONG INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS

Complainant

and

CHAN WAI DUNE CHARLES
TEH DOLORES ENG-HUA
YAU HOK HUNG
CCIF CPA LIMITED

1st Respondent

2nd Respondent

3rd Respondent

4th Respondent

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

Members: Mr. Lam Ken Chung, Simon (Chairman)
Mr. Wong Wing Yan Kenneth
Mr. Lam Chi Ki
Mr. Grant Jamieson
Ms. Li Yin Fan Fanny

Dates of hearing: 1st and 3rd September 2021

Date of Decision: 31 December 2021

DECISION

I. Introduction

The 1st, 2nd and 3rd Respondents are and at material times were certified public accountants (practising). The 4th Respondent is a corporate practice under which the 1st, 2nd and 3rd Respondents provide and at all material times provided their professional services.

2. On 9 November 2018, the Acting Registrar of the Hong Kong Institute of Certified Public Accountants (“**HKICPA**”) received a complaint from the Financial Reporting Council (**FRC**) against the Respondents, alleging failure or neglect to observe, maintain or otherwise apply professional standards under section 34(1)(a)(vi) of the Professional Accountants Ordinance Cap. 50 (“**the Ordinance**”), in relation to audit services that the Respondents provided to a listed company called First Natural Foods Holdings Limited (currently known as Imperial Pacific International Holdings Limited) (“**the Company**”) and its subsidiaries (collectively “**the Group**”), for the years ended 31 December 2005 to 31 December 2007.

3. The Registrar of HKICPA, by a letter dated 16 October 2019 (“**the Complaint Letter**”), submitted the complaint to the Council of HKICPA, which in the exercise of its discretion referred the complaint to the Disciplinary Panels. This Disciplinary Committee (“**the Committee**”) has been constituted to deal with the complaint.

II. Background

4. The Company was incorporated in Bermuda; its shares are and at all material times were listed on the Main Board of the Hong Kong Stock Exchange. At the material time, the Company was an investment holding company and its subsidiaries were principally engaged in manufacturing and sale of sea food products. The Group’s turnover appears at all material times to have been mainly contributed by a subsidiary called Fuqing Longyu Food Development Co., Ltd. (福清隆裕食品開發有限公司) (“**Fuqing Longyu**”), which was incorporated in mainland China.

5. The 4th Respondent audited the consolidated financial statements of the Group for the years ended 31 December 2005, 2006 and 2007 (respectively “**the 2005 Audit**”, “**the 2006 Audit**” and “**the 2007 Audit**”), and expressed unmodified auditor’s opinions in relation to all of them. The relevant auditor’s reports also stated that the audits were conducted in accordance with the Hong Kong Standards on Auditing (“**HKSA**”) applicable at the time. The 1st Respondent, the 2nd Respondent and the 3rd Respondent were the engagement directors for the 2005 Audit, the 2006 Audit and the 2007 Audit respectively.

6. The trading of the Company’s shares in the Hong Kong Stock Exchange was suspended in December 2008, apparently due to inability to meet its debt obligations. The Company petitioned for winding-up in January 2009, and provisional liquidators were appointed. It was then discovered that, in respect of Fuqing Longyu, two separate sets of accounts existed, which were substantially different in material respects, and that there were forged sales records.

7. FRC received a complaint from a regulator in April 2015, alleging possible auditing irregularities. The Audit Investigating Board (**AIB**) of the FRC conducted an investigation into the matter, and produced an investigation report dated 8 November 2018 (“**the AIB Report**”). As a result of the investigation, a complaint was made to the Acting Registrar of HKICPA as aforesaid. The **AIB Report** has been made part and parcel of the evidence before this Committee.

III. The complaints

8. There are a total of 5 complaints in this case, as contained and set out in the Complaint Letter. All complaints allege breach of section 34(1)(a)(vi) of the Ordinance. Section 34 of the Ordinance provides that

- “(1) A complaint that -
 - (a) a certified public accountant –
 - ...
 - (vi) failed or neglected to observe, maintain or otherwise apply a professional standard;
 - ...

shall be made to the Registrar who shall submit the complaint to the Council which may, in its discretion but subject to section 32D(7), refer the complaint to the Disciplinary Panels.”

9. Section 34(1AA) of the Ordinance further provides that the provisions of, *inter alia*, section 34(1)(a)(vi) of the Ordinance shall apply *mutatis mutandis* in relation to a corporate practice and accordingly, a complaint under section 34(1) may be made against such a practice.

10. The 5 complaints may be summarized as follows:

- (a) The 1st and 2nd complaints are in relation to the 2005 Audit, against the 1st and 4th Respondents:
 - (i) First Complaint: The 1st and 4th Respondents failed or neglected to observe, maintain or otherwise apply professional standards in carrying out the *audit planning and risk assessment* in the 2005 Audit;
 - (ii) Second Complaint: The 1st and 4th Respondents failed or neglected to observe, maintain or otherwise apply professional standards in *auditing the Group's turnover and accounts receivables* in the 2005 Audit;
- (b) The 3rd complaint is in relation to the 2006 Audit, against the 2nd and 4th Respondents:

Third Complaint: The 2nd and 4th Respondents failed or neglected to observe, maintain or otherwise apply professional standards in *auditing the Group's turnover and accounts receivables* in the 2006 Audit; and
- (c) The 4th and 5th complaints are in relation to the 2007 Audit, against the 3rd and 4th Respondents:
 - (i) Fourth Complaint: The 3rd and 4th Respondents failed or neglected to observe, maintain or otherwise apply professional

standards in *auditing the Group's turnover and accounts receivables* in the 2007 Audit; and

- (ii) Fifth Complaint: The 3rd and 4th Respondents failed or neglected to observe, maintain or otherwise apply a professional standard in *auditing the Group's transactions with a significant customer* in the 2007 Audit.

IV. The evidence before the Committee

11. The documentary evidence before this Committee is contained in Part 1 of a Hearing Bundle prepared for the purpose of this hearing. Neither party challenges the authenticity or admissibility of the documents contained therein. Besides, in the course of the hearing, the Complainant produced, without objection from the Respondents, a copy of the Hong Kong Standard on Auditing 500 – Audit Evidence (version applicable at the times material to this complaint). This document was marked as **Exhibit C1**. The Respondent, on the other hand, also produced without objection from the Complainant a prospectus of the Company published at the time of its initial public offer in 2002. This document was marked as **Exhibit R1**.

12. As far as witness statements are concerned, the Respondents had intended to adduce witness statements from Mr. CHAN Wai Dune Charles (1st Respondent), Mr. YEUNG Sik Hung Alvin and Mr. YAU Hok Hung (3rd Respondent), and to call them as witnesses in the disciplinary hearing. This was objected to by Mr. Samuel Yip, who represented the Complainant. The main ground of Mr. Yip's objection was that the contents of the witness statements have already been contained in the documents and earlier submissions produced or made by the Respondents to the AIB. Mr. Gary Lam, who appeared on behalf of the Respondents, however pointed out that the main purpose of the witnesses being called was to confirm what is contained in the relevant audit working papers. Unless the content of the working papers was unchallenged, he was obliged to call the witnesses to affirm it. Mr. Yip then indicated that while the Complainant was not in a position to admit the content of the working papers, since the Complainant did not have knowledge about it, the Complainant would not dispute them either. The Complainant would leave it to the Committee to decide whether to accept the content as facts. Upon Mr. Yip's clarification of the Complainant's stance, Mr. Lam indicated that, in that case, there

was no need for the witness statements to be adduced, or for the witnesses to be called.

13. This disciplinary hearing was therefore conducted on documentary evidence only.

V. The First Complaint

14. The First Complaint concerns the auditor's planning and assessment of the risk level in relation to the 2005 Audit.

15. HKSA 315¹ ("*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*") contains the following provisions:

"100. The auditor should **identify and assess the risks** of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. For this purpose, the auditor:

- **Identifies risks** throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- **Relates the identified risks to what can go wrong at the assertion level;**
- Considers whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and
- Considers the likelihood that the risks could result in a material misstatement of the financial statements." (Emphasis added)

"122. The auditor should **document**:

- (a) The discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;
- ...

¹ All HKSA provisions cited herein were those applicable at the material times of these complaints.

- (b) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 100; ...

... ” (Emphasis added)

16. HKSA 330 (*The Auditor’s Procedures in Response to Assessed Risks*) also provides:

“7. The auditor should design and perform further audit procedures whose nature, timing, and extent are **responsive to the assessed risks of material misstatement at the assertion level**. The purpose is to provide a **clear linkage** between the nature, timing, and extent of the auditor’s **further audit procedures** and the **risk assessment**. In designing further audit procedures, the auditor considers such matters as the following:

- The significance of the risk.
- The likelihood that a material misstatement will occur.
- The characteristics of the class of transactions, account balance, or disclosure involved.
- The nature of the specific controls used by the entity and in particular whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity’s controls are effective in preventing, or detecting and correcting, material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.” (Emphasis added)

“73. The auditor should **document** the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of those audit procedures, including the conclusions where these are not otherwise clear. ... ” (Emphasis added)

17. In the Audit Planning Memorandum prepared by the 4th Respondent for the 2005 Audit, there is a section VI, entitled “*Significant Accounting and Auditing Issues*”. Under this section, it was stated:

“1. Accounts Receivable and sales – **medium risk**

The accounts receivable increased from RMB 67 million to RMB 73 million. However, the total sales had a minor decrease from RMB 435 million to RMB 434 million. We will perform analytical review and recoverability test to assess whether the provision for receivable is sufficient.

During the year, the issue of 孔雀石綠 [Malachite Green] occurred, which affected the Group’s sales of seafood, eel. We will make enquiries with the Company’s management for the impact on the Group’s turnover and check with the relevant sales documents.” (Emphasis added)

18. The Complainant’s case is that, despite what has been set out in paragraph 17 above, the audit documentation did not show any evidence that the 1st or 4th Respondent had identified and assessed the specific risks of material misstatement at the assertion level. Furthermore, the audit documentation did not show that the 1st and 4th Respondents had designed and performed further procedures responsive to the assessed risks of material misstatement at the assertion level, and/or document how further audit procedures performed (if any) were linked to those assessed risks. The 1st and 4th Respondents had therefore failed to meet the standards set out in paragraphs 15 and 16 above.

19. The Respondents’ case on this complaint is that the relevant HKSAAs had been satisfied, by reason of what was stated in the Audit Planning Memorandum, as set out in paragraph 17 above. Mr. Lam submitted that two risks were properly identified, viz., (a) the risk of overstatement of receivables; and (b) the risk caused by the chemical issue (i.e., Malachite Green). Mr. Lam also submitted that further procedures were designed and performed in relation to both risks. In respect of the overstatement of receivables, the auditor intended to and did perform analytical review and recoverability test to assess whether the provision for receivable was sufficient; in respect of the chemical issue, the auditor intended to and did make enquiries with the Company’s management about the impact of the Malachite Green issue on the Group’s turnover, and checked with the relevant sales documents.

20. This Committee takes the view that the very specific requirements under the relevant HKSAAs could not have been met by the general and vague statements contained in the Audit Planning Memorandum (paragraph 17 above). By the time of the 2005 Audit, the 1st Respondent had been auditing the Group for 7 years. He

should be well aware of the complicated nature of the Group. The not insubstantial increase (of about 9%) in accounts receivables, in circumstances where sales volume had decreased (albeit slightly), and where the Group was troubled by the Malachite Green incident, ought to have raised an alarm in the mind of the auditor. Yet, the auditor merely pointed out the phenomena, but did not identify or assess the risks that might be behind such phenomena. The audit procedure said to have been designed in response to possible risks, as documented, was also too vague and general.

21. It must be borne in mind that the First Complaint is about audit planning and assessment, *not* about whether adequate audit procedures were *in fact* carried out. The latter would be the subject matter of the Second Complaint. Since audit planning and assessment are required to be documented, this Committee will consider the sufficiency of the audit planning and assessment of the 2005 Audit on the basis of what was stated in the Audit Planning Memorandum (as set out in paragraph 17 above). After due consideration, this Committee has no difficulty in concluding that the planning and assessment was inadequate. This Committee agrees with the Complainant's observations, contained in paragraphs 28 to 30 of the Complainant's Case, that:

“28. According to paragraph 100 of HKSA 315, the auditor was required to:

- (a) Identify risks associated with turnover. (For example, the risk of overstatement of sales either due to fraud or error arising from sales made via I/E agents².)
- (b) Relate the identified risks to what can go wrong at the assertion level. (For example, the risk of sales being wrongly recognized when sales invoices had been issued to the I/E Agents but the goods had not been delivered to the ultimate customers, which would affect the assertion of sales occurrence.)
- (c) Assess the magnitude and likelihood that the identified risks could result in a material misstatement of the financial statements. (For example, given majority of the Group's sales were made via the I/E agents and no direct confirmation of sales could be obtained from the ultimate customers³, it is likely that the abovementioned risks, which are of a significant magnitude, could result in a material misstatement of the financial statements.)

² More will be said about the I/E agent in paragraphs 28 to 34 below.

³ Please see paragraph 29 below for further details in this respect.

29. After the above risks assessment has been done, the auditor should design and perform further audit procedures which are responsive to the assessed risks of material misstatement at the assertion level, in accordance with paragraph 7 of HKSA 330. The purpose is to provide a clear linkage between the design of the audit procedures and the risk assessment.
30. Referring to the above example, the auditor would need to design the nature, timing and extent of audit procedures that are responsive to the risk of overstatement of sales arising from the non-occurrence of sales made via the I/E agents.”

22. It is to be noted that the HKSAs obviously place strong emphasis on the assessment of risks and audit planning *right at the start* of the auditing job. This is important, for such risk assessment and audit planning guide the direction and way that the audit should be conducted, and allows the auditor to focus on specific areas of concern. Poor risk assessment and planning invariably result in poor auditing job.

23. This Committee unanimously finds the First Complaint proved to its satisfaction against both the 1st and 4th Respondents.

VI. The Second Complaint

VI A. Overview of the Second Complaint

24. The Second Complaint concerns the professional standards applied by the 1st and 4th Respondents in the auditing of the Group’s turnover and accounts receivables in the 2005 Audit.

25. In the Complaint Letter, this complaint was pursued under three limbs:
- (a) Failure to obtain appropriate consistent audit evidence;
 - (b) Failure to evaluate the impact of a customer’s non-response to audit confirmation request; and
 - (c) Deficient alternative procedures for unreturned confirmations on accounts receivable.

26. The third limb, set out in paragraph 25(c) above, is no longer pursued by the Complainant. This Committee is therefore only concerned with the first and second limbs, set out in paragraph 25(a) and (b) above.

VI B. Failure to obtain appropriate consistent audit evidence

27. Paragraph 12 of HKSA 500 provides as follows:

“The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from a management representation. Conversely, 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.**”
(Emphasis added)

28. In the audit working paper titled “TURNOVER” for the 2006 Audit (Index MI), details of sales transactions of Fuqing Longyu through its PRC import and export agents (often abbreviated I/E agents) are provided, under the heading “Sale Transaction through Import and Export Companies”, as follows:

- “Most of the Group’s products, mainly marine food products and functional food products, are eventually sold to ultimate customers in Japan and the U.S. mainly through import/export companies in the PRC. The import/export companies are mainly engaged to **arrange shipments and act as collection agents** on behalf of the Group.

The Group negotiates and signs sales contracts with overseas ultimate customers directly. The Group then assigns specific import/export company, which has a legally binding contractual relationship with the Group, to **arrange for shipment, export quota, documentation and foreign exchange clearance relating to the sales order.**

After a purchase order is confirmed by the ultimate customer, the Group will proceed with the production of the products ordered. ... After the production period, the import/export company will **arrange shipment** to the overseas ultimate customer based on the shipment terms provided by the

Group. Major terms include specifications of products to be delivered, shipping terms mainly by Free on Board (FOB), quantity of products, consideration of the products, the delivery time, and settlement term.” (Emphasis added)

- “The settlement term by overseas ultimate customers is by Letter of Credit (L/C) or Remittance (T/T) to the import/export company, the balance is normally due within 3 months from the date of billing. The Group then delivers the ordered products to the ultimate customer through the import/export company, **the Group will bear all the goods damage, lost and complaint by the ultimate [customer].**” (Emphasis added)
- “The import/export company will convert the foreign currency received from the ultimate customer for the products delivered into RMB and pay to the Group that the amount [*sic*] after deducting a service charge ... **Any debts from the ultimate customers will be borne by the Group.**” (Emphasis added)

29. The same audit working paper, under the heading “Audit approach to confirm Trade receivables and Sale through I/E companies ... ”, stated:

- “The Company issued sale invoices to I/E companies, and sale invoices to ultimate customers were issued by I/E companies. **According to our past audit experience, we can 't obtain audit confirmation directly from ultimate customers,** as the I/E companies also sourced goods and products from other suppliers for the ultimate customers and all invoices issued directly by I/E companies to ultimate customers.

In practice, **it was difficult for the ultimate customers to record and confirm the outstanding balance for each original suppliers.** Instead, they usually settled the outstanding balance by L/C which in the name of the I/E companies and kept the book records in the name of the I/E companies.

During our field work this year, we enquired with [name], Account Manager, to confirm our understanding stated above and he confirmed that **the ultimate customers cannot confirm the year ended outstanding balance in Trade receivables and the amount of sales in our client 's book records,** as the **ultimate customer considered they are having transactions with the I/E Companies and not the Company.**

Therefore, we considered that **alternatively to send the audit confirmations to I/E companies and test checked the sale invoice** issued to I/E companies by the Company, sale invoice issued by I/E companies to ultimate customers and shipping documents such as bill of lading.” (Emphasis added)

- “Since the Company was negotiated [*sic*] the sale term with the ultimate customers and all I/E companies will deliver the goods to the end users when the I/E companies received L/C or T/T issued by the end users for settled the debts. As the shipping terms is [*sic*] usually using by FOB, sale amount recognised when goods delivered to the I/E companies and which was the same day on board, therefore the sale of the Company recognised by date of bill of lading or 商品調撥單. Moreover, the Company is issued [*sic*] sale invoices to I/E companies and the I/E companies are issued [*sic*] sale invoices to end users. ” (Emphasis added)

30. The audit working paper titled “TURNOVER” for the 2007 Audit (Index Q1) documented similar details as set out in paragraphs 28 and 29 above.

31. From paragraph 1.5 of the 4th Respondent’s letter dated 15 February 2019 to the HKICPA, it is apparent that the same situation also applied to the 2005 Audit, and thus the Second Complaint.

32. The Complainant contends that, on the one hand, the auditor accepted that the Group made sales to the ultimate customers but on the other hand, the auditor accepted the management’s assertion that the ultimate customers did not consider themselves as transacting with the Group. There is no evidence on any procedure that was performed to address and resolve such inconsistency.

33. The Respondents’ case in this respect is that there was no inconsistent audit evidence at all, and therefore no question of any additional audit procedure being necessary to resolve such inconsistency. The Respondents say that it is common practice for overseas customers to source products from more than one supplier in mainland China. Accordingly, in practice, while the Group reasonably considered that it made sales to the ultimate customers and kept records of the sales amount for each of the ultimate customers, the same cannot be assumed in reverse. The ultimate overseas customers would only have proper and complete records of the total goods sourced from and invoiced by the I/E agents, rather than from the suppliers (including the Group). The Respondents therefore submit that there was no inconsistent audit

evidence, and therefore no basis for requiring additional audit procedures to be designed and performed.

34. This Committee considers the information provided by the management of the Group to be rather inconceivable. The Group did sign sales contracts with the overseas ultimate customers. Before the commencement of production of goods under each contract, purchase orders were issued by the Group and confirmed by the ultimate customer. As such, both the Group and the ultimate customer should be on the same page in relation to the description of the goods supplied, the quantity, as well as the price under the contract/ purchase order (though the amount might be somewhat different from that eventually paid to the I/E agent and actually received by the Group, by reason of fees that might have to be paid to the I/E agent). Furthermore, albeit that the I/E agent might supply goods to the same ultimate customer from different sources, the ultimate customer must be able to tell which goods came from which supplier for, according to the management, “the Group [would] bear all the goods damage, lost and complaint by the ultimate [customer]”. Even assuming that the ultimate customer might not be in a position to confirm the year-end outstanding balance (which in itself would be surprising), there was no reason why they could not at least confirm the quantity of goods supplied by the Group. The Group’s management however informed the auditor that “the ultimate customer considered they [were] having transactions with the I/E Companies and not the Company”. There must have been inconsistent audit evidence coming from the Group itself, which was suspicious. The auditor should have determined what additional audit procedures were necessary to resolve the inconsistency, the most obvious of which must be enquiring with the ultimate customers directly. However, the auditor was content with representations from the management of the Group, and did not approach the ultimate customers of indirect sales made through the I/E agents at all. This was highly unsatisfactory.

VI C. Failure to evaluate the impact of a customer’s non-response to audit confirmation request

35. Paragraph 6 of HKSA 200 (*Objectives and General Principles Governing an Audit of Financial Statements*) provides as follows:

“The auditor should plan and perform an audit with an attitude of **professional skepticism** recognizing that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional skepticism means

the auditor makes a **critical assessment**, with a **questioning mind**, of the validity of audit evidence obtained and is **alert to audit evidence that contradicts or brings into question the reliability of documents or management representations**. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of overgeneralizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.”

36. Paragraph 3.1.2.8 of the AIB Report states as follows:

“Audit confirmations were sent to Customer A during the 2005 Audit, the 2006 Audit and the 2007 Audit, in which each of these confirmations only included the requests to confirm the actual sales amounts from the **direct sales** (i.e. **excluding the amounts generated from sales through the PRC import and export agents**) and the outstanding balances of receivables from **direct sales** as at the respective year end date. No responses to the audit confirmations were received from Customer A and [the 4th Respondent] had performed alternative audit procedures for these non-responses. The details of the alternative audit procedures performed are set out in Section 4.1.2.” (Emphasis added)

37. Customer A was the largest customer of Fuqing Longyu (and of the Group). The relevant audit working papers show that sales to customer A represented 29% of the Group’s turnover in 2005. Most of sales were indirect sales through I/E agent(s). The quantity of direct sales amounted to 5.8% of the total sales of Fuqing Longyu; the rest were indirect sales. Audit confirmation request was sent to Customer A in relation to direct sales only. Customer A did not respond. No audit confirmation was sent to Customer A in relation to indirect sales.

38. The 4th Respondent did carry out alternative procedures for the unreturned confirmation on accounts receivable by Customer A, which involved the checking of sales invoices, goods delivery notes and bills of lading, and the settlement of trade receivables that took place during the year on a sampling basis. The Complainant has now withdrawn his earlier allegation that such alternative procedures were deficient (as far as *direct sales* to Customer A is concerned). The remaining

question is whether the impact of the non-confirmation ought to have been assessed in the wider context, involving *both* direct and *indirect sales*, and in relation to all customers concerned.

39. This Committee finds the total failure by the auditor to reach out to the ultimate customers of indirect sales, despite Customer A's failure to respond to request for audit confirmation, to be disquieting, to say the least. In this regard, please see paragraph 34 above. It is insufficient, from an auditing point of view, to seek verification only from the I/E agents. No evidence has been adduced in relation to the reliability of the I/E agents. Despite submissions made on the Respondents' behalf by Mr. Lam, this Committee is unable to take judicial notice, simply because the I/E agents might be state owned, that they *must* be credible and reliable. This Committee agrees with the observation of the AIB, contained in paragraph 3.2.8 of its report, that:

“During the 2005 Audit, the 2006 Audit and the 2007 Audit, no responses to the confirmation requests were received from Customer A (Paragraph 3.1.2.8). There was no evidence that [the 4th Respondent] had performed audit procedures to elicit responses. The AIB considers that the recurring non-responses from Customer A should have raised [the 4th Respondent]'s concern about the occurrence of sales to Customer A who was the largest customer of Fuqing Longyu. [The 4th Respondent] should have performed audit procedures, such as directly contacting Customer A, to ascertain (i) whether the address as stated in the confirmation requests was correct; and (ii) the reason why Customer A did not respond to the confirmation requests if they had received such requests. In this respect, the AIB considers that [the 4th Respondent] failed to maintain a questioning mind in accordance with paragraph 6 of HKSA 200 for the 2005 Audit and in accordance with paragraph 15 of HKSA 200 (Revised) for the 2006 Audit and the 2007 Audit.”

40. The auditor had failed to adopt an attitude of sufficient professional skepticism, and the assessment made was not critical enough, in the circumstances of the case.

VI D. Conclusion on the Second Complaint

41. By reason of the above, this Committee agrees that, in relation to the 2005 Audit, the 1st and 4th Respondents had failed to obtain sufficient and appropriate audit evidence on turnover and accounts receivables in accordance with HKSA 500, and had further failed to perform the audit with an attitude of professional skepticism in accordance with HKSA 200. They had therefore failed or neglected to observe,

maintain or otherwise apply professional standards in auditing the Group's turnover and accounts receivables in the 2005 Audit. This Committee therefore unanimously finds the Second Complaint proved to its satisfaction.

VII. The Third Complaint

VII A. Overview of the Third Complaint

42. The Third Complaint concerns the professional standards applied by the 2nd and 4th Respondents in the auditing of the Group's turnover and accounts receivables in the 2006 Audit.

43. This complaint is pursued under three limbs:

- (a) Failure to obtain appropriate consistent audit evidence;
- (b) Failure to evaluate the impact of a customer's non-response to audit confirmation request; and
- (c) Failure to ensure completeness of population in the sampling transactions test on turnover.

VII B. Failure to obtain appropriate consistent audit evidence

44. The relevant information in the audit working paper for the 2006 Audit has already been set out in paragraphs 28 and 29 above. The discussions under paragraphs 32 to 34 above also apply.

VII C. Failure to evaluate the impact of a customer's non-response to audit confirmation request

45. The analysis in paragraphs 35 to 40 above also applies to the 2006 Audit, except that the applicable HKSA provision became paragraph 15 of HKSA 200 (Revised) (*Objective and General Principles Governing an Audit of Financial Statements*) which states:

“The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.”

46. The change in the applicable HKSA provision does not affect the analysis.

VII D. Failure to ensure completeness of population in the sampling transactions test on turnover

47. Paragraph 11 of HKSA 500 (*Audit Evidence*) provides:

“When information produced by the entity is used by the auditor to perform audit procedures, **the auditor should obtain audit evidence about the accuracy and completeness of the information.** In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be **sufficiently complete and accurate.** For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity’s information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information.” (Emphasis added)

48. Furthermore, paragraphs 35 and 35a of HKSA 530 (*Audit Sampling and Other Means of Testing*) provide as follows:

“35. It is important for the auditor to ensure that the population is:

- (a) **Appropriate to the objective** of the audit procedure, which will include consideration of the direction of testing. For example, if the auditor’s objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers’ statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and

(b) **Complete.** For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed. Similarly, if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period. A different approach may be to stratify the population and use sampling only to draw conclusions about the control activity during, say, the first 10 months of a year, and to use alternative audit procedures or a separate sample regarding the remaining two months. ...” (Emphasis added)

“35a. The auditor is required to obtain audit evidence about the accuracy and completeness of information produced by the entity’s information system when that information is used in performing audit procedures. When performing audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently **complete and accurate**. HKSA 500 paragraph 11 contains additional guidance on the audit procedures to perform regarding the accuracy and completeness of such information.” (Emphasis added)

49. In the audit working paper for the 2006 Audit, under “Sales compliance test” (Index O1), the test of controls on sales transactions was documented as follows:

“Objective: To ensure that the procedures and internal controls as described by management are properly implemented and reliance can be placed upon. Moreover, Sales are not materially understated and have been properly and accurately recorded in the appropriate accounting period.

Population: All sales during the year.

Source document Sale invoice

Basis of selection: Select 10 material transactions

Audit procedures:

1. Select samples as mentioned above from sales register and drop down the details of goods sold
2. Match the details with purchase order from customers with sale invoice
3. Check if the sale order approved by director

4. Check if the 商品調撥單 approved by Head in warehouse (To I/E company or direct sales)
5. Check for authorization on sales invoices (the “Company invoices”) issued from the Company to I/E company or end user (direct sales)
6. Check for authorization on sales invoices issued from the I/E company to ultimate customers
7. Check the Company invoices match with I/E invoices
8. Check the details of packing list match with sales invoice and bill of lading
9. Check stock ledger as per 出貨單 and packing list of finished goods approved by sale department
10. Check posting of accounting entry:
 Dr. Accounts receivable
 Cr. Sales
11. Check settlement date

Findings: No material irregularity was noted.

Results: Satisfactory.

Conclusion: Objective achieved.”

50. Furthermore, in the audit working paper entitled “Sales Cut-off Test (For I/E Sales)” (Index O3-1), the sales cut-off test was documented as follows:

“Objective: To ensure all sales have been recorded in the proper accounting period.

Population: All sales arised [sic] during [2006] & [2007].

Source document: 商品調撥單 / Sales invoices and bill of lading

Cut-off criteria: Good delivered / received date.
 - For overseas client or I/E companies using FOB shipping term, so when delivered to the board, the Company recognised the sales.
 Checked to bill of lading

Sample: Select last 5 and first 5 商品調撥單 immediately before and after the year ended date.

Audit procedures:

- 1) Extract details from 商品調撥單 selected
- 2) Check to sales invoice or bill of lading
- 3) Check posting to G/L
- 4) Check whether recorded under cut-off criteria (i.e. date in 商品調撥單)

Findings: No irregularity was found.

Conclusion: Objectives achieved”

51. The Complainant relies on the following observation of the AIB, contained in paragraph 3.2.15 of its report:

“The AIB notes that the objective as stated in the cut-off tests performed for the 2006 Audit and the 2007 Audit was to ensure that turnover was recorded in the appropriate accounting periods ..., rather than testing the completeness of sales invoices, internal goods delivery notes (商品調撥單) or packing lists. Regardless of whether the “source documents” used as the population for selecting samples for the “Sales compliance test” were sales invoices, internal goods delivery notes (商品調撥單) or packing lists, the AIB finds that [the 4th Respondent] **did not perform any sequence test** to ascertain the completeness of these documents during the 2006 Audit and the 2007 Audit. Since they were the population used for selecting samples in the “Sales compliance test” performed for the 2006 Audit and the 2007 Audit ..., failure to test their completeness was a non-compliance with paragraph 11 of HKSA 500, and paragraphs 35 and 35a of HKSA 530.” (Emphasis added)

52. The gist of this limb of the complaint is that the working paper for the “Sales compliance test” indicated that sample transactions were selected from “all sales during the year”, and that the source documents were the sales invoices. There is however no evidence that any audit procedure, such as a sequential test, was performed to ascertain the completeness of the documents from which sample transactions were selected for the “Sales compliance test”.

53. The Respondents submitted that sequential tests were in fact carried out “by way of cut off tests”, in “[selecting] last 5 and first 5 商品調撥單 immediately

before and after the year ended date”⁴. 商品調撥單, which term was translated “internal goods delivery notes” in the AIB Report, was explained by Mr. Lam on behalf of the Respondent to be documents issued by the Group’s marketing department for goods delivered. Mr. Lam did not say whether the deliveries were “internal” (probably meaning within the Group) or to outside customers. The words “調撥” (relocate) would suggest that there were internal maneuvers. In any event, 商品調撥單 were different from sales invoices. It is not known how any procedure carried out to ascertain the completeness of the former could enhance the population of the latter. The Committee agrees with the Complainant’s submission, that the fact that the first five goods delivery notes selected after the 2005 year-end date from the 2005 Audit were in sequential order, and that the last five goods delivery notes selected from the 2006 Audit were in sequential order, was not sufficient evidence about the completeness of the population of the 2006 sales invoices.

54. The next point that the Respondents made is that there is no question about sales invoices being incomplete, as the audit team had checked 100% of the sales invoices, and no exception was noted. Reference was made to one page of the audit working papers (Index M1a) (B557) in support of the contention. A perusal of that page of the audit working papers however does not show 100% checking of the sales invoices at all. It merely stated “test checked to sale invoices issued”. Mr. Lam in the course of the hearing did not insist on there being documentary support of the Respondents’ contention in this regard. To the contrary, the audit working paper for the “Sales compliance test” (Index O1) clearly stated that only 10 material transactions were selected. The list of accounts receivables (應收賬款明細表) attached as Appendix 5 of the audit working papers (C38) also shows that the figures were merely “test checked to invoices issued”. 100% checking is not what auditors would normally do. Had that in fact been done, it would certainly have been documented. The reality of the situation in the present case is however that not only is there no documented evidence of 100% checking, there is actually documented evidence to the contrary. Furthermore, since no sufficient audit procedure was carried out to ensure the completeness of the population, how could the 4th Respondent be sure that they had checked 100% of the sales invoices, even if they were minded to do so? In short, this Committee has no difficulty rejecting the Respondents’ contention that 100% checking was conducted.

⁴ Paragraph 73(b) of the Respondents’ Case.

55. The Respondents also contended that other audit procedures were performed on inventories and accounts receivables, such as confirmation of sale from key customers and I/E agents, review of subsequent settlement on accounts receivable, bank account reconciliations, inventory tests, review of post-balance sheet material transactions and analytical review of the margins.

56. As indicated in paragraph 49 above, these audit steps were taken in relation to the “Sales Compliance test”. Irrespective of whether the audit sampling performed is sufficiently **complete and accurate**, checking subsequent settlement of the relevant trade receivables, as well as inventories tests, could not sufficiently ascertain the existence assertion, while analytical review of the margins was only a high level comparison of data, and could not ensure the completeness of the population of sales invoices used in the test of sales transactions.

57. All in all, this Committee finds that the 2nd and 4th Respondents had failed to ensure completeness of population in the sampling transactions test on turnover.

VII E. Conclusion on the Third Complaint

58. By reason of the above, this Committee agrees that, in relation to the 2006 Audit, the 2nd and 4th Respondents had failed to obtain sufficient and appropriate audit evidence on turnover and accounts receivables in accordance with HKSA 500, had failed to perform the audit with an attitude of professional skepticism in accordance with HKSA 200, and had further failed to ensure the completeness of population in the sampling transactions test on turnover in accordance with HKSA 500. They had therefore failed or neglected to observe, maintain or otherwise apply professional standards in auditing the Group’s turnover and accounts receivables in the 2006 Audit. This Committee therefore unanimously finds the Third Complaint proved to its satisfaction.

VIII. The Fourth Complaint

59. The Fourth Complaint concerns the professional standards applied by the 3rd and 4th Respondents in the auditing of the Group’s turnover and accounts receivables in the 2007 Audit.

60. As for the Third Complaint, this complaint is also pursued under three limbs:

- (a) Failure to obtain appropriate consistent audit evidence;
- (b) Failure to evaluate the impact of a customer's non-response to audit confirmation request; and
- (c) Failure to ensure completeness of population in the sampling transactions test on turnover.

61. The material facts pertaining to this complaint are identical to that of the Third Complaint. As the Committee finds the Third Complaint proved, the Committee also unanimously finds the Fourth Complaint proved to its satisfaction.

IX. The Fifth Complaint

62. The Fifth Complaint concerns auditing the Group's transactions with a significant customer in the 2007 Audit.

63. HKSA 230 (*Audit Documentation*) contains the following provisions:

- "9. The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:
 - (a) The nature, timing, and extent of the audit procedures performed to comply with HKSAs and applicable legal and regulatory requirements;
 - (b) The results of the audit procedures and the audit evidence obtained; and
 - (c) Significant matters arising during the audit and the conclusions reached thereon."
- "16. The auditor should document discussions of significant matters with management and others on a timely basis."
- "17. The audit documentation includes records of the significant matters discussed, and when and with whom the discussions took place. It is not limited to records prepared by the auditor but may include other appropriate records such

as agreed minutes of meetings prepared by the entity's personnel. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity."

64. The Complainant's case in this regard is that, at the material time, there was an indirect wholly-owned subsidiary of the Company called Jia Jing Commercial (Shanghai) Co., Ltd. ("**Jia Jing**"). The legal address of Jia Jing, as stated in a rental agreement entered into by it in September 2007, was "Flat C3, 13th Floor, No. 528 Laoshan Road".

65. On the other hand, there was a customer of the Group called "Shanghai Joyance", whose address as stated in the audit working papers for the 2007 Audit was "Flat C3, 13th Floor, Purple Mountain Hotel, No. 528 Laoshan Road East, Pudong, Shanghai City". It is undisputed that the relevant outstanding accounts receivables balance of Shanghai Joyance, as shown in the Group's 2007 financial statements, exceeded the audit materiality set by the 4th Respondent.

66. As the address of a material customer of the Group apparently shared the same address as one of the Company's wholly-owned subsidiaries, the matter ought to be an issue for audit query.

67. In the course of the AIB's investigation, the 3rd and 4th Respondent informed the AIB that, during audit, they had enquired with the management of the Group, and was given to understand that Jia Jing had used the address of Shanghai Joyance as a correspondence address for the purpose of entering into the rental agreement. The said communication was however not documented in the audit papers. The 3rd and 4th Respondents are therefore alleged to have acted in breach of the above-mentioned provisions of HKSA 230.

68. The Respondents' case in this regard, broadly speaking, is premised upon two arguments:

- (a) The matter is not material enough to be documented; and
- (b) The 4th Respondent had conducted sufficient audit procedures to verify the sales with Shanghai Joyance.

69. In relation to materiality, it is undisputed that the volume of transactions with Shanghai Joyance exceeded the materiality test set by the 4th Respondent itself. Shanghai Joyance was the seventh largest customer of Fuqing Longyu for domestic sales. In 2007, sales to Shanghai Joyance amounted to RMB 34.7 million. Although it represented only 4.7% of the Group's total turnover for the year, it cannot be said to be insignificant. It was significant enough to cause the 4th Respondent to make enquiry with the Group. It was also significant enough, according to the Respondents, to cause the 4th Respondent to conduct further investigation on Shanghai Joyance. The use of a common address would have raised the suspicion that Shanghai Joyance was related to the Group, and casted doubt on the genuineness of the sales concerned. Since the 4th Respondent had seen fit to take reasonable steps to address the suspicion and doubt, it should have documented the steps taken as well.

70. The second point taken by the Respondents (paragraph 68(b) above) is in the Committee's view misconceived. It might be that the 4th Respondent had taken other audit procedures to address the same suspicion and doubt, and it might be that these other audit procedures were properly documented. That does not however excuse an auditor from documenting an audit procedure that ought to have been documented but was not.

71. This Committee therefore finds that the 3rd and 4th Respondents failed or neglected to observe, maintain or otherwise apply a professional standard in auditing the Group's transactions with a significant customer in the 2007 Audit, viz., Shanghai Joyance. The Committee unanimously holds that the Fifth Complaint has been proved to its satisfaction.

X. Conclusion and other matters

72. It is therefore the Committee's unanimous decision that all five complaints herein have been proved to its satisfaction. It was a common consensus of the parties, reached in the course of the hearing, that the appropriate sanction orders should be determined by this Committee in writing, after considering written submissions from the parties.

73. This Committee therefore gives the following directions:

- (a) The Complainant shall submit his written submissions (copied to the Respondents) on the questions of sanctions, costs, fees and other consequential matters (if any) within 21 days from the date of this Decision;
- (b) The Respondents shall submit their written submissions (copied to the Complainant) on the questions of sanctions, costs, fees and other consequential matters (if any) within 21 days thereafter; and
- (c) There be liberty to the parties to apply in writing for other directions, or to vary the above directions, if considered necessary.

Lam Ken Chung Simon
Chairman
Disciplinary Panel A

Lam Chi Ki
Member
Disciplinary Panel A

Grant Jamieson
Member
Disciplinary Panel B

Wong Wing Yan Kenneth
Member
Disciplinary Panel A

Li Yin Fan Fanny
Member
Disciplinary Panel B

Mr. Samuel Yip, legal representative of the Complainant

Mr. Gary Lam, instructed by Messrs. Clyde & Co., for the Respondents