

IN THE MATTER OF

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

BETWEEN

An Investigation Committee of the Hong Kong Institute of Certified Public Accountants

COMPLAINANT

AND

1st Respondent

FIRST

RESPONDENT

2nd Respondent

SECOND

RESPONDENT

Members:

ORDER AND REASONS FOR DECISION

1. This is a complaint made by an Investigation Committee of the Hong Kong Institute of Certified Public Accountants ("**the Institute**") as Complainant against the Respondents, 1st Respondent, a certified public accountant (practising) and 2nd Respondent, a firm of certified public accountants. Section 34(1)(a)(vi) of the PAO applied to the Respondents.
2. The complaints as set out in a letter dated 10 January 2013 ("**Complaints**") from the Investigation Committee of the Institute to the Registrar of the Institute were as follows:-
 - (a) First Complaint - Section 34(1)(a)(vi) of the PAO applies to the Respondent in that they failed or neglected to observe, maintain or otherwise apply Statement of Auditing Standards ("**SAS**") 402.5 because, when performing the external confirmation procedures on the [Group]'s suppliers overseas and banks in mainland China, they failed to maintain control over the preparation and sending of the confirmation requests and the responses to those requests.

- (b) Second Complaint - As an alternative to the First Complaint, section 34(1)(a)(vi) of the PAO applies to the Respondents in that they failed or neglected to observe, maintain or otherwise apply SAS 230.1 because they failed to document the procedures adopted for the purposes of maintaining control over the preparation and sending of the confirmation requests and the responses to those requests which were important in providing evidence to support their audit opinion.
 - (c) Third Complaint - Section 34(1)(a)(vi) of the PAO applies to the Respondents in that they failed or neglected to observe, maintain or otherwise apply SAS 400.1 because they did not obtain sufficient appropriate evidence on which they could reasonably draw their unqualified conclusion regarding the existence and valuation of the deferred development cost of the IVSS project amounting to HK\$40,857,000 at 31 December 2002.
 - (d) Fourth Complaint - As an alternative to the Third Complaint, section 34(1)(a)(vi) of the PAO applies to the Respondents in that they failed or neglected to observe, maintain or otherwise apply SAS 230.1 because they failed to document those procedures they followed when reaching their unqualified conclusion regarding the existence and valuation of the deferred development cost of the IVSS project amounting to HK\$40,857,000 at 31 December 2002 which were important in providing evidence to support their audit opinion.
3. On 23 October 2013, the Disciplinary Committee issued a Notice of Commencement of Proceedings, enclosing a procedural timetable and a full set of the complaint documents to the parties.
4. The parties made a joint request for variation of procedures to the disciplinary proceedings on 4 December 2013. The Respondents admit the Second Complaint and the Fourth Complaint aforementioned. They do not dispute the facts as set out in the Respondents' admitted facts attached to the letter dated 4 December 2013. The background leading to the complaints were as follows:
- (a) Company A was registered in the Cayman Islands on 14 August 2001 and listed on the Main Board of the Stock Exchange of Hong Kong on 28 June 2002 (Stock Code 691). It was principally engaged in (i) the provision of advisory and management services and the distribution of hardware and software for intelligent building projects in the PRC; and (ii) the trading of intelligent building equipment, software and accessories in the PRC.
 - (b) The Second Respondent, a firm of certified public accountants (practising) registered with the Institute, was the reporting accountant in respect of Company A's IPO. The Second Respondent issued an unqualified Accountants' Report dated 18 June 2002 for the purposes of Company A's IPO. The responsible engagement partner was the First

Respondent. The Second Respondent was also appointed auditor in respect of Company A's financial statements for the year ended 31 December 2002 ("2002 Financial Statements").

- (c) On about 1 April 2003 during the course of the audit of the 2002 Financial Statements, an anonymous letter dated 31 March 2003 was sent to the Second Respondent, copied to the Commercial Crime Bureau and the Independent Commission Against Corruption (the "ICAC"). The anonymous letter alleged that the First Respondent and another staff member of the Second Respondent had committed certain irregularities during Company A's IPO process. In response, the Second Respondent established a special task force to look into the matter. After undertaking specific procedures, the task force concluded that the allegations set out in the anonymous letter could not be substantiated. The Second Respondent proceeded with the audit of the 2002 Financial Statements with the 1st Respondent as the engagement partner. On 28 April 2003, the Second Respondent issued an unqualified audit report in relation to the 2002 Financial Statements.
- (d) On 1 September 2004, following Investigations by the ICAC, the Chairman and an executive director of Company A were convicted in the District Court of conspiring to use false business documents in connection with Company A. The Financial Controller of Company A, Mr. L, and other employees were granted immunity from prosecution in return for giving evidence.
- (e) The shares of Company A were suspended from trading since 9 June 2003. Company A was delisted in March 2005.
- (f) On 10 June 2003, the Council of the Institute resolved to set up an Investigation Committee (the "IC") to look into the work performed in relation to Company A by the Second Respondent and the conduct of Mr. L, who was a Certified Public Accountant. The initial directions to the IC related to the IPO. The directions were subsequently extended in December 2008 to include the audit of the 2002 Financial Statements. In December 2011, Mr. L admitted to a disciplinary committee that he had been guilty of dishonourable conduct.
- (g) On 15 November 2011, the IC issued a report of its findings in relation to the Respondents, "Report of the Investigation Committee relating to Company A (in so far as it concerns the 2nd Respondent and its engagement partner)" (the "IC Report"). In the IC Report, the IC concluded that, were complaints to be made against the Respondents under section 34(1)(a)(vi) of the Professional Accountants Ordinance (the "PAO") that they failed or neglected to observe, maintain or otherwise apply a professional standard, the 2nd Respondent and the 1st Respondent would each have a case to answer.

- (h) The IC, however, did not find that any member of the 2nd Respondent had been involved in the irregularities perpetrated in relation to Company A's IPO process and the 2002 Financial Statements.
 - (i) The working papers regarding the 2002 audit were seized by the ICAC to assist with their investigations. The Second Respondent asserted that some of the working papers were missing from the audit files returned to the firm by the ICAC. A letter from the 2nd Respondent to the IC dated 16 February 2011 indicated that the ICAC made no formal response to the 2nd Respondent's request for the missing working papers. As a result, there is an issue whether the IC did have a full set of the working papers when preparing the IC Report although the IC was not aware that the potentially missing working papers would have affected the evidential basis on which its findings and conclusions were made.
- 5. As agreed by the parties, the Disciplinary Committee sets out its direction on 14 February 2014 that:
 - a) The First and Third Complaints (which are not admitted) will remain on the Institute's record and are not to be proceeded with unless any of the Respondents at any time withdraw their admissions in respect of the respective alternative complaints.
 - b) in respect of the Second and Fourth Complaints,
 - i) the Disciplinary Committee agrees to the parties' proposal to dispense with the steps as set out in Rules 17 to 30 of the DCPR in light of the admissions made by the Respondents.
 - ii) the Disciplinary Committee agrees to waive steps 1 to 7 of the Procedural Timetable dated 23 October 2013.
 - iii) the Complainant and the Respondents are to make written submissions to the Disciplinary Committee as to the sanctions and costs which should be imposed by the Disciplinary Committee pursuant to Rule 31 of the Disciplinary Committee Proceedings Rules.
- 6. The Respondents filed joint submissions dated 21 March 2014. The Complainant filed submissions dated 24 March 2014.
- 7. The Respondents rely by way of mitigation on their admission of the complaints, the “relatively minor” nature of the admitted complaints, the improved documentation mechanism within the 2nd Respondent and submit that the sanction should be a reprimand, and if there is any penalty it should be imposed on 2nd Respondent alone as the 1st Respondent has endured significant pressure and strain as a result of the investigation and complaint. They also express remorse.

8. In asserting that the admitted complaints are relatively minor in nature, the Respondents also assert that, whilst they accept there were breaches of SAS 230.1 for failing to document certain audit procedures, they should be judged by the prevailing practice of auditors in 2003 rather than the practice at the time of the IC investigation in 2011 or today. It is asserted that it was not common practice among auditing firms in 2003 to record the finer aspects of the procedures applied for conducting the external confirmation process. There is no evidence to support the Respondents' assertions of the prevailing practice in 2003. In any event, it is no answer to a finding of inadequate compliance with a professional standard to barely assert that other auditing firms were similarly culpable. The Disciplinary Committee agrees with the Complainant that documentation is an important part of the audit process, as it serves to explain the procedures performed and their outcome.
9. The Disciplinary Committee has regard to the fact that the auditing deficiencies were in respect of the financial statements of a listed company. Further, the 2nd Respondent gave an unqualified audit report on 28 April 2003, but the trading of the shares was suspended on 9 June 2003, and members of management were convicted on 1 September 2004 of conspiracy to use false business documents. There is no suggestion of the Respondents having been involved in any dishonest activities of the company's management. However, it is precisely because of the potential for such dishonest activities by management that compliance with proper auditing procedures is so important, particularly in the context of public companies. No information is provided to the Disciplinary Committee as to the extent to which proper auditing documentation by the Respondents might have disclosed the company's irregularities, nor the extent of any losses suffered by reason of the unqualified audit report. In the absence of such information, the Disciplinary Committee does not treat the unqualified auditing report in the context of dishonest management activities as an aggravating factor, but in the context, it does not regard the admitted auditing deficiencies as "minor".
10. The Respondents assert that the 2nd Respondent has over the years reviewed and improved its auditing practices, including the introduction of an electronic audit tool in 2007-2008 for better planned and structured audit documentation, and such improved practices have helped to address the inadequacies identified in the admitted complaints. This is noted.
11. The Respondents assert that they (particularly the 1st Respondent) have endured significant strain and pressure as a result of the investigation and complaint. No further detail is provided. The Disciplinary Committee acknowledges that dealing with an investigation and/or complaint is always likely to be stressful. However, where the investigation and complaint are justified (as evidenced by the admissions), a certain amount of strain and pressure inherent in the proceedings which follow is to be expected and is self-inflicted. This cannot alone be regarded as a mitigating factor.
12. The 1st Respondent has no prior disciplinary record.

13. The Disciplinary Committee notes that the Second Respondent does not have a clear disciplinary record, but was the subject of an order on 18 March 2014, which order and the reasons for decision have been supplied at the request of the Disciplinary Committee. That case concerned the failure to apply different professional standards in the preparation and issuance of accounts and the audit of financial statements, in concurring with the wrong calculation of EPS. (In that matter, the individual practitioner respondent had already been sanctioned by the Second Respondent, and this may have been relevant when the relevant disciplinary committee in that case decided to order a penalty against only the Second Respondent).
14. The purpose of ordering a penalty is to serve as a deterrent, not compensation. There is no reason in this case why a deterrent is not appropriate for both Respondents. The amount of penalty required to serve as a deterrent may well differ between respondents.
15. The Disciplinary Committee further notes that the Respondents do not oppose the costs order sought by the Complainant in respect of the costs of the investigation and the disciplinary proceedings.
16. In considering the proper order to be made in this case, the DC has had regard to all the aforesaid matters, including the particulars in support of the Complaint, the parties' submissions on sanctions and costs and their conduct throughout the proceedings.
17. The Disciplinary Committee ORDERS that:-
 - (a) the First Respondent and the Second Respondent be reprimanded under section 35(1)(b) of the PAO;
 - (b) the First Respondent pay a penalty of HK\$35,000 under section 35(1)(c) of the PAO;
 - (c) the Second Respondent pay a penalty of HK\$50,000 under section 35(1)(c) of the PAO;
 - (d) the Respondents do pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$550,000 under section 35(1)(iii) of the PAO.

Dated the 17th day of June 2014