

IN THE MATTER OF

Complaints made under section 42C(1) of the Professional Accountants Ordinance (Cap. 50)

BETWEEN

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

AND

Mr. Kwok Chee Tack (F00769)	1 <sup>st</sup> RESPONDENT
Mr. Wong Kam Man Kevin (F01750)	2 <sup>nd</sup> RESPONDENT
Ernst & Young (0422)	3 <sup>rd</sup> RESPONDENT

Before a Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants ("**Institute**").

Members:                   Dr. WILSON Claire (Chairman)  
                                  Mr. LAM Sze Cay Kevin  
                                  Mr. LI Ka Fai David  
                                  Mr. ESPINA Anthony Joseph

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**ORDER & REASONS FOR DECISION**

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1. These are complaints made by an Investigation Committee of the Institute ("**Complainant**") against the Respondents under section 42C(1) of the Professional Accountants Ordinance (Cap. 50) ("**PAO**"). The disciplinary proceedings are:
  - (a) complaints against Mr. Kwok Chee Tack ("**Kwok**"), a certified public accountant (practising) and Ernst & Young ("**EY**"), a firm of certified public accountants (practising) relating to the audits of Yue Fung International Group Holding Limited ("**Yue Fung**") (case no. D-03-IC13Q);

- (b) complaints against Mr. Wong Kam Man Kevin ("**Wong**"), a certified public accountant (practising) and EY relating to the accountants' reports and audits of Gold Wo International Holdings Limited ("**Gold Wo**") (case no. D-03-IC14Q); and
  - (c) complaints against Kwok and EY relating to the accountants' reports and audits of Fu Cheong International Holdings Limited ("**Fu Cheong**") (case no. D-03-IC15Q).
2. The original complaints are set out in three complaint documents from the Complainant ("**Original Complaints**") which were transmitted to the Disciplinary Committee ("**Committee**") under cover of a letter dated 13 March 2017.
  3. On 28 November 2017, the Committee approved the parties' joint applications by letters dated 1 November 2017 to amend the Original Complaints to the amended complaints ("**Amended Complaints**") set out in the documents annexed to the parties' letters of 1 November 2017.
  4. The Amended Complaint for case no. D-03-IC13Q is as follows:
    - (1) Based on the Investigation Committee's observations of the audit evidence, they consider that Respondents failed to apply relevant auditing standards and guidelines in respect of sales and receipts for sales.
    - (2) After consideration, the Investigation Committee ("**IC**") has identified the following breaches in professional standards.

#### **Complaint**

- (3) With respect to sales and receipt for sales in the audits of 1999, 2000, 2001 and 2002, the Respondents did not comply with the following Statements on Auditing Standards ("**SAS**"):
  - (i) SAS 400 to obtain sufficient appropriate audit evidence to satisfy themselves that sales were fairly stated; and
  - (ii) SAS 230 to document the work performed or the judgment made on matters important to the audit opinions of the relevant financial statements.

*Audit Evidence - Sales testing*

- (4) IC considers that the Respondents' working papers did not contain sufficient evidence to indicate that Yue Fung had effective controls over the sales cycle and integrity of warehouse records. As a result, a reasonable auditor would have been alert of the potential risks of misstatement when planning and performing the audit.
- (5) Although the Respondents conducted various tests relating to the existence and quantity of sales, the audit evidence was not sufficient to substantiate shipments and related payments, which typically would be sourced from external parties.
- (6) Databank products constituted a significant portion of Yue Fung's sales and would, therefore, be subject to test work. However, proof of customer acknowledgement was rarely inspected and documents showing identity of customers settling sales receivables were not inspected for any of the databank product sales.
- (7) In respect of sales to PRC customers, the shipments were made by a local delivery service which did not provide proof of delivery. There was, however, inadequate evidence reflecting that the Respondents had evaluated the potential risks associated with this deviation from the standard practice and/or the legality of transactions which would have been subjected to the laws and rules of another jurisdiction.
- (8) The IC also considered that there was insufficient evidence to confirm that sales actually reflected the finished goods delivered to customers, since the Goods Delivery Notes ("GDNs") were not consistently used in sequential order and were not prepared for all sales transactions.
- (9) Furthermore, source documents that were generated by third parties showing delivery of goods to customers were inspected in less than 80% of the sales transaction samples selected.
- (10) Source documents pertaining to sales receipts, such as bank advice or cheque copies, were not inspected by the Respondents in the sales transaction testing, and direct audit evidence obtained did not adequately support that settlement was actually made by sales customers.

- (11) The working papers reflected a lack of evidence showing control over the accounts receivable circularization process and adequate testing of sales receipts. Furthermore, given the internal control deficiencies related to GDNs and the accounting records, the accuracy of total sales was questionable and the accounts receivable confirmations had limited evidential value in verifying the annual sales figures. A reasonable auditor would have been expected to gather additional evidence to ensure the sales were properly reflected in the financial statements.

*Documentation*

- (12) Even if Respondents conducted the necessary audit procedures which the IC considers lacking, the Respondents did not comply with SAS 230 in documenting the work performed or the judgment made on matters important to the audit opinions of the relevant financial statements.

5. The Amended Complaint for case no. D-03-IC14Q is as follows:

- (1) The Investigation Committee ("IC") determined that the Respondents failed to apply relevant auditing standards and guidelines in respect of the following key audit areas:
  - (a) Sales and receipts for sales;
  - (b) Purchases (cost of sales) and related cash disbursements; and
  - (c) Deposit for acquisition of long term investment and investment held for disposal.
- (2) The IC identified the following breaches in professional standards.

**Complaint 1**

- (3) With respect to the audit areas relating to (a) sales and receipts of sales and (b) purchases (cost of sales) and related cash disbursements in the audits of 2000, 2001 (7 months), 2001 and 2002, and (c) the deposit for acquisition of long term investment held for disposal in the 2002 audit, the Respondents did not comply with the following Statements on Auditing Standards ("**SAS**"):
  - (i) SAS 400 to obtain sufficient appropriate audit evidence to satisfy themselves that sales and purchases were fairly stated and that

SSAP 20 had been applied in ascertaining disclosures of certain related party transactions;

- (ii) SAS 230 to document the work performed or the judgment made on matters important to the audit opinions of the relevant financial statements;
- (iii) SAS 200 to plan the audit and SAS 300 in assessing risks related to the audits; and
- (iv) SAS 100 to maintain an attitude of professional skepticism when planning and performing the audits.

*Audit Evidence - Sales testing*

- (4) The Respondents conducted various tests relating to the existence and quantity of sales including, inter alia, sales transaction testing, cash receipts testing, sales cut-off testing and circularization of accounts receivable (AR) balances. Although there were unusual findings noted by the Respondents in the test work performed in relation to the PRC sales<sup>1</sup>, they considered the results of these tests satisfactory.
- (5) The results of the Respondents' test work showed there was insufficient evidence to support the recording of PRC sales, and that sales processing differed from the Respondents' understanding which was documented in the system audit working papers. The following points were identified by the Respondents:
  - (a) goods received were acknowledged by two agents instead of actual customers;
  - (b) PRC sales were not recorded in the AR sub-ledger;
  - (c) receipts of substantial portions of PRC sales were made in cash; and

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<sup>1</sup> PRC sales were significant to Gold Wo's operations. Gold Wo entered into a processing arrangement with an external party to undertake the manufacturing function in the PRC. Under PRC law, mainland entities in the processing industry with no foreign trading rights cannot sell goods in the PRC domestic market. Accordingly, Gold Wo had to rely on certain PRC agents to handle the sales to its PRC customers. Proper testing should have included an assessment of the role and eligibility of the PRC agents as well as Gold Wo's compliance with PRC rules on exports, custom duties, and domestic sales tax obligations.

- (d) certain PRC sales were settled through the current account with Fu Chu Kan ("Fu"), the founder of Gold Wo, or through the inter-company current account.
- (6) The IC also determined that there was insufficient evidence to confirm that sales actually reflected finished goods delivered to the PRC customers, as the Goods Delivery Notices ("GDNs") were not pre-numbered and used in sequential order, nor were they prepared for all sales transactions.
- (7) The working papers reflected a lack of evidence showing control over the accounts receivable circularization process and consideration of related party disclosure requirements resulting from the sales that were recorded through an inter-company current account. Furthermore, although the audit team had obtained confirmations from Gold Wo's customers, accounts receivable confirmations would have limited evidential value in verifying the annual sales figures since the internal control deficiencies related to PRC sales.

*Audit Evidence - Purchase testing*

- (8) The Respondents conducted various tests relating to the purchase cycle including, inter alia, purchase transaction tests, cash payment tests, purchase cut-off tests and accounts payable circularization.
- (9) The results of the Respondent's test work showed there was insufficient evidence to support the recording of purchases of raw materials in the PRC that were handled by Fu. Such transactions were processed in a manner that differed from the other purchases transactions, as documented in the system working paper files. The following observations were noted by the Respondents:
  - (a) Suppliers' invoices on certain bank payments related to purchases of raw materials made by Fu on behalf of Gold Wo were unavailable for inspection;
  - (b) a significant portion of purchases were posted to the current account with Fu instead of AP sub-ledger in 2000; and
  - (c) Significant portion of payments were recorded in the current account with Fu in 2000 and 2001.

- (10) The IC concluded that additional audit evidence would be required to support that purchases were actually received by the warehouse. The Respondents should have followed up on why the Goods Receipts Notes ("GRNs") were not consistently pre-numbered and in sequential order and were not prepared for all purchase transactions.
- (11) Additionally, although the Respondents performed some work in response to their findings, the nature of these bank payments, which were paid through a director's account, should have prompted an auditor to make further enquiries to understand the reasonableness of and proper accounting for the payments.
- (12) The working papers reflected a lack of evidence showing control over the accounts payable circularization process and consideration of related party disclosure requirements resulting from the purchases that were recorded through an inter-company current account. Furthermore, although the audit team had obtained confirmations from Gold Wo's suppliers, given that the internal control deficiencies related to certain purchases, accounts payable confirmations would have limited evidential value in verifying the annual purchase figures.
- (13) The Respondents performed purchase transaction testing which consisted of inspecting bank statements and bank-in-slips. However, because these documents did not contain reference to a specific vendor, this increased the risks that the payment may not have been made for purchase transactions. Although the purchase transaction system remained the same across the years, in some years a smaller sample was selected for testing without sufficient justification.
- (14) Lastly, the Respondents' system audit working papers failed to clearly reflect that purchases were processed differently depending on whether they were classified as "HK Purchases" or "PRC Purchases."
- (15) The matters noted by the Respondents should have raised doubt over the accuracy of purchases recorded and prompted additional audit work. However, the Respondents did not make adequate enquiries to resolve issues related to the unusual transactions.

#### *Audit Evidence - Analytical procedures*

- (16) Analytical procedures should be performed near the end of the audit when auditors form an overall conclusion as to whether the financial statements are consistent with their understanding of the business.
- (17) The IC considered that the analytical review procedures had not been diligently conducted to obtain corroborating evidence to support the Respondents' understanding of the business. Specifically, the Respondents did not perform analytical review processes to compare Gold Wo's actual sales trends to relevant industry trends and related production trends. Furthermore, the Respondents accepted the management's explanation for changes in the overall gross profit margins from 1998 to 2002 without challenging its reasonableness.

#### *Audit Evidence - Investments*

- (18) As at 31 March 2002, the audited financial statements reflected a deposit for acquisition of long term investment of \$10 million and an investment with a disposal value of \$14 million. There were indications that the IPO share subscription proceeds may have funded the investments, which deviated from the intended use of the proceeds disclosed in the Prospectus.
- (19) The Respondents performed test work on the two investments and reviewed the relevant legal documents. However, from an auditing perspective there appears to be insufficient evidence of genuine existence of the investments, insufficient evidence to demonstrate that the funding source of the investments was not the application of IPO proceeds and inadequate explanation of the purpose of such investments.

#### *Documentation*

- (20) Even if the Respondents conducted the necessary audit procedures which the IC considers lacking, the Respondents did not comply with SAS 230 in documenting the work performed or the judgment made on matters important to the audit opinions of the relevant financial statements.

#### *Audit Planning and Risks Assessment*

- (21) Auditors are required to develop and document an overall audit plan and to assess audit risks in their planning and performance of an audit. There is

no evidence to demonstrate that the Respondents revised their overall audit plan as needed and/or gained proper understanding of the accounting systems and related internal controls.

- (22) In particular, there is no evidence to demonstrate that Respondents had performed the following:
- (a) identified and evaluated sufficient key controls applied by the Group to ensure that total sales and purchases were accurately reflected in the financial statements;
  - (b) conducted adequate procedures to address various internal control weaknesses;
  - (c) developed an appropriate plan that would consider the legality and financial flow of transactions regarding PRC sales; and
  - (d) considered additional audit procedures in light of the findings noted by the audit team during sales and purchase testing.
- (23) Furthermore, the working papers do not sufficiently reflect that the Respondents properly assessed known risks when determining the design and extent of substantive procedures.

*Professional Skepticism*

- (24) The IC determined that the Respondents should have exercised adequate professional skepticism in light of the following circumstances:
- (a) there were contract processing arrangements in the PRC with strict rules imposed on foreign manufacturers which needed to be scrutinised by the Respondents during the planning and execution of the audit;
  - (b) the current account of Fu reflected a high volume of fund movements and transactions with a related party in unusual situations which should have warranted the Respondent's to seek further understanding, further evaluation and documentation; and

- (c) the relatively late inclusion of the results of Top Executive in the course of Gold Wo's listing application, as it was a material contributor to the total profits of the Group.

## **Complaint 2**

- (25) The Respondents failed to adequately review the preceding auditors' work for 1998 and 1999, to document the work performed as part of the review and to perform relevant analytical procedures in accordance with Statements 1.200 and 3.340 for the purpose of the Accountants' Report.
- (26) A reporting accountant is required to determine the extent to which they are able to rely on the audit work already performed by preceding auditors. However, the Respondents did not provide sufficient documentation as evidence that they had adequately evaluated the assurance work performed on the sales and purchases cycles by the prior year auditors. In addition, there is insufficient evidence to show that they had re-performed some of the assurance work on Top Executive, a subsidiary which comprised 57% of profits of the Group, to meet the profits threshold imposed by the Stock Exchange for listing applicants.
- (27) In particular, the IC considers that there were a number of risk factors related to the prior year audits. However, the files/documentation fail to reflect how the Respondents gained sufficient understanding of the risks to properly address potential consequences.

6. The Amended Complaint for case no. D-03-IC15Q is as follows:

- (1) The IC determined that the Respondents failed to apply relevant auditing standards and guidelines in respect of the following key audit areas:
  - (a) Sales and receipts for sales; and
  - (b) Purchases (cost of sales) and related cash disbursements.
- (2) The IC has identified the following breaches in professional standards:

### **Complaint 1**

- (3) With respect to the audit areas relating to (a) sales and receipts of sales and (b) purchases (cost of sales) and related cash disbursements in the audits of 2000 and 2001 (9 months), the Respondents did not comply with the following Statements on Auditing Standards ("**SAS**"):
- (i) SAS 400 to obtain sufficient appropriate audit evidence to satisfy themselves that sales and purchases were fairly stated and that SSAP 20 had been applied in ascertaining disclosures of certain related party transactions;
  - (ii) SAS 230 to document the work performed or the judgments made on matters important to the audit opinions of the relevant financial statements;
  - (iii) SAS 200 to plan the audit and SAS 300 in assessing risks related to the audits; and
  - (iv) SAS 100 to maintain an attitude of professional skepticism when planning and performing the audits.

#### *Audit Evidence - Sales testing*

- (4) The Respondents conducted various tests relating to the existence and quantity of sales including, inter alia, sales transaction testing, cash receipts testing, sales cut-off testing and circularization of sales and accounts receivable balances. Although there were unusual factors noted by the Respondents in the test work performed in relation to sales settled by cash, they considered the results of these tests satisfactory.
- (5) Notwithstanding the fact that the Respondents performed audit procedures, there was insufficient audit evidence to determine whether the relevant receipts were indeed settlements made by sales customers, given that:
- (a) many of the cash receipts were firstly recorded in Fu Cheong's cash log book and then shown as "lump sum" deposits in bank statements or accounting records; and
  - (b) many of the cash receipts were not matched to specific invoice amounts and appears to have been allocated to customer accounts as cash receipts without matching invoices.

- (6) The IC also determined that there was insufficient evidence to confirm that sales actually reflected finished goods delivered to customers as the Goods Delivery Note ("GDNs") were not consistently used in sequential order nor were they prepared for all sales transactions.
- (7) The working papers reflected a lack of evidence showing control over the sales and accounts receivable circularization process and adequate testing of sales receipts. Furthermore, given the internal control deficiencies related to GDNs and the accounting records, the accuracy of total sales was questionable and a reasonable auditor would have been expected to gather additional evidence to ensure the transactions underlying "lump sum" payments were properly reflected in the financial statements.

*Audit Evidence - Purchase testing*

- (8) The Respondents conducted various tests relating to the purchase cycle including, inter alia, purchase transaction tests, cash payment tests, purchase cut-off tests and circularization of purchases and accounts payable. The Respondents noted some unusual findings when conducting their test work but considered the results satisfactory.
- (9) The results of the Respondents' work showed that there was insufficient evidence to support the recording of purchases from the PRC suppliers and subsequent payments. The following observations were noted by the Respondents for a significant portion of audit samples selected:
  - (a) invoice copies, suppliers' GDNs and purchase orders were not available for inspection;
  - (b) purchases were recorded based on suppliers' statements rather than actual source documents; and
  - (c) purchase payments were not consistently posted to the sub-ledger and/or supported by cheque copies.
- (10) The IC also concluded that the audit evidence gathered by the Respondents was insufficient to confirm that the purchases recorded were actually received by the warehouse. Results of test work was not sufficient to show that proper support was obtained for all purchase transactions selected or that proper control over source documents was maintained.

- (11) Additionally, the unusual nature of various payments by Fu Cheong should have prompted an auditor to make further enquiries to understand the reasonableness of and proper accounting for the payments, especially in light of the number of cash and lump sum settlements.
- (12) The working papers reflected a lack of evidence showing control over the purchase and accounts payable circularization process and consideration of related party disclosure requirements resulting from the cash purchase payments made by Ho Wing Cheong, one of Fu Cheong's founders. Furthermore, given that the internal control deficiencies related to certain purchases and the accounting records, the accuracy of total purchases was questionable and accounts payable confirmations would have limited evidential value in verifying the annual purchase figures.
- (13) Purchase transaction testing consisted of inspecting bank statements and bank-in-slips which did not contain reference to a specific vendor, thereby failing to mitigate the risk that the payment may not have been made for purchases.
- (14) Lastly, the Respondents' system audit working papers did not reflect the fact that purchases were processed differently, depending on whether they were classified as "HK Purchases" or "PRC Purchases."
- (15) The Respondents' findings should have raised doubt over the accuracy of purchases recorded and should have prompted extra test work. However, the Respondents did not make adequate enquiries to resolve issues related to these transactions.

*Audit Evidence - Analytical procedures*

- (16) Analytical procedures should be performed near the end of the audit when auditors form an overall conclusion as to whether the financial statements are consistent with their understanding of the business.
- (17) The IC determined that the analytical review procedures had not been diligently conducted to obtain corroborating evidence to support the Respondents' understanding of the business. Specifically, the Respondents did not perform analytical review processes to compare Fu Cheong's actual sales trends to relevant industry trends and related production trends. Furthermore, the Respondents accepted management's explanation for

changes in the overall gross profit margins from 1998 to 2001 without challenging its reasonableness.

*Documentation*

- (18) Even if the Respondents had conducted the necessary audit procedures which the IC considers lacking, the Respondents did not comply with SAS 230 in documenting the work performed or the judgment made on matters important to the audit opinions of the relevant financial statements.

*Audit Planning and Risks Assessment*

- (19) Auditors are required to develop and document an overall audit plan and to assess audit risks in their planning and performance of an audit. The available evidence does not demonstrate that the Respondents revised their overall audit plan as needed and/or gained proper understanding of the accounting systems and related internal controls.
- (20) In particular, there was no evidence to demonstrate that the Respondents had performed the following:
- (a) identified and evaluated sufficient key controls applied by the Group to ensure that total sales and purchases were accurately reflected in the financial statements;
  - (b) conducted adequate procedures to address various internal control weaknesses;
  - (c) developed an appropriate plan that would consider the commercial substance of the transfer of business to Fortune BVI and related complicating factors;
  - (d) considered additional audit procedures in light of the findings noted by the audit team during sales and purchase testing; and
  - (e) developed an overall audit plan for 2001 (9 months).
- (21) Furthermore, the working papers do not sufficiently reflect the fact that the Respondents properly assessed known risks when determining the design and extent of substantive procedures.

### *Professional Skepticism*

- (22) The IC determined that the Respondents should have exercised adequate professional skepticism in light of the following:
- (a) treatment of cash sales receipts and purchases payments, and aggregate "lump sum" recording;
  - (b) the volume of purchase payments which were made through Ho; and
  - (c) lack of reliability of source documents inspected by the Respondents and the overall reliability of the accounting records.

### **Complaint 2**

- (23) The Respondents failed to adequately review the preceding auditors' audit work for 1998 and 1999, to document the work performed as part of the review and to perform relevant analytical procedures in accordance with Statements 1.200 and 3.340 for the purpose of the Accountants' Report.
- (24) A reporting accountant is required to determine the extent to which he is able to rely on the audit work already performed by preceding auditors. However, the Respondents did not provide sufficient documentation to evidence that they had adequately evaluated the assurance work performed on the sales and purchases cycles by the prior year auditors. In addition, there is insufficient evidence showing how the prior year auditors dealt with significant changes in the principal activities of subsidiaries that recorded sales of the Group, in particular:
- (a) the activities of Fortune HK, which provided 100% of the Group sales in 1998, which subsequently ceased to operate and whose business was transferred to another subsidiary (Ford Reach) in November 1998 effective from 1 January 1999; and
  - (b) the subsequent transfer of assets and liabilities by Ford Reach to Fortune BVI in September 1999.
- (25) The IC determined that there were a number of risk factors relating to the prior year audits but there was insufficient audit documentation to reflect how the Respondents gained sufficient understanding of the risks to properly address potential consequences.

7. The Respondents have admitted the Amended Complaints against them. On 1 November 2017, the parties agreed that the steps set out in Rules 17 to 30 of the Disciplinary Committee Proceedings Rules ("DCPR") be dispensed with.
8. On 28 November 2017, the Committee agreed to the parties' joint applications to dispense with the steps set out in Rules 17 to 30 of the DCPR in light of the admissions of the Amended Complaints made by the Respondents and directed the parties to make written submissions on sanctions and costs.
9. The Complainant provided their submissions on sanctions and costs on 22 December 2017. EY provided their written submissions on sanctions and costs on 24 January 2018. Kwok and Wong provided their submissions on sanctions on 25 January 2018.
10. The Committee has considered the submissions made by the Complainant and Respondents.
11. In considering the order to be made in this case, the Committee has had regard to all the aforesaid matters, including the particulars in support of the Amended Complaints, and the conduct of the Complainant and Respondents throughout the proceedings.
12. The Complaints are found to be proven on the basis of the Respondents' admissions.
13. The Committee notes that it has wide discretion on the sanctions that may be imposed. Each matter is fact sensitive and the Committee is not bound by the decisions of previous Committees. Having considered all of the relevant facts, the Committee, in its determination of the level of financial penalty to be imposed, has taken into account the respective professional roles held by each of the Respondents.
14. The Committee has also considered EY's request that the Complainant should not be awarded the full amount of costs, and that costs should be reduced to a total of around HK\$1.2 million. After full consideration of further submissions made by both the Complainant and EY on the matter of costs the Committee could not find any basis to justify EY's request for the reduction of costs awarded.
15. The Committee orders that:-

- (a) all of the Respondents be reprimanded under section 35(1)(b) of the PAO;
- (b) Kwok do pay a penalty of HK\$200,000 under section 35(1)(c) of the PAO;  
Wong do pay a penalty of HK\$100,000 under section 35(1)(c) of the PAO;  
and EY do pay a penalty of HK\$400,000 under section 35(1)(c) of the PAO;  
and
- (c) the Respondents do pay jointly and severally the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$1,527,416 under Section 35(1)(iii) of the PAO.

Dated the 18th day of July 2018

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Dr. WILSON Claire (Chairman)

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Mr. LI Ka Fai David

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Mr. LAM Sze Cay Kevin

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Mr. ESPINA Anthony Joseph